

WATFORD_{RE}



FINANCIAL CONDITION REPORT
2016

FINANCIAL CONDITION REPORT

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INTRODUCTION

Watford Re Ltd. (“Watford” or “the Company” or “we” or “our”) is a global insurance and reinsurance company licensed as a Class 4 insurer by the Bermuda Monetary Authority (the “BMA”) in Bermuda. Watford is a wholly owned subsidiary of Watford Holdings Ltd. (“WHL”). In March 2014, WHL raised \$1.1 billion in our initial funding, and we began underwriting reinsurance in the first half of 2014.

Our strategy combines a diversified, casualty-focused underwriting portfolio, accessed through our strategic relationship with Arch Capital Group Ltd. and its subsidiaries (“Arch”), with a disciplined investment strategy comprising primarily non-investment grade corporate credit assets, managed by HPS Investment Partners LLC (“HPS”). We have designed our investment strategy to complement the characteristics of our underwriting portfolio in order to generate attractive risk-adjusted returns for our shareholders.

We and our operating subsidiaries all carry a financial strength rating of “A-” (Excellent) with a stable outlook from A.M. Best Company, or A.M. Best, which is the fourth highest of 15 ratings that A.M. Best confers.

SECTION A – BUSINESS AND PERFORMANCE

Name of the Insurer

Watford Re Ltd.
Waterloo House, 1st Floor
100 Pitts Bay Road
Pembroke, HM 08
Bermuda

Supervisors

Insurance Supervisor:

Bermuda Monetary Authority
BMA House
43 Victoria Street
Hamilton
Bermuda

Group Supervisor:

As of December 31, 2016 Watford Re had not been designated by the Bermuda Monetary Authority as a Designated Insurer for group supervision purposes as defined in The Insurance Act 1978, as amended (the “Insurance Act”). As of December 31, 2016 Watford is not subject to group supervision by the BMA.

Subsequent to December 31, 2016 the BMA sought group supervision. On March 31, 2017 the BMA notified Watford that that it intended to seek group supervision for the Company. On May 5, 2017 Watford was deemed to be group supervised by the BMA.

Approved Auditor

PricewaterhouseCoopers Ltd.
Dorchester House
7 Church Street
Hamilton HM 11
Bermuda

Ownership details

The Company is a wholly owned subsidiary of WHL. Please refer to Appendix 1 for an overview of the corporate structure.

Insurance Business Written

The Company writes insurance and reinsurance specialty lines on a worldwide basis. Product lines include: (i) casualty reinsurance; (ii) property catastrophe reinsurance; (iii) other specialty lines reinsurance (consisting of mortgage, other specialty lines, property excluding property catastrophe, marine and aviation and other lines); and (iv) insurance programs and coinsurance (consisting primarily of casualty, other specialty, and property excluding property catastrophe).

Gross premiums written were \$535.1 million for the year ended 31 December 2016 compared to \$488.9 million for the year ended 31 December 2015, an increase of \$46.2 million, or 9.4%. Our 2016 premium growth was due to the continued expansion of Watford's U.S. and European insurance programs and coinsurance while the reinsurance portfolio remained stable. Gross premiums written were split between the below segments and geographic locations:

	2016	2015	2014
<i>(\$ in thousands)</i>			
Gross premiums written:			
Casualty reinsurance	315,578	325,323	181,479
Other specialty reinsurance	140,953	138,695	97,592
Property catastrophe reinsurance	11,756	12,716	9,556
Insurance programs and coinsurance	66,807	12,165	
Total	535,094	488,899	288,627
Net premiums written:			
Casualty reinsurance	313,600	320,620	179,054
Other specialty reinsurance	132,816	122,703	86,122
Property catastrophe reinsurance	11,463	12,440	9,280
Insurance programs and coinsurance	55,909	10,196	—
Total	513,788	465,959	274,456
Net premiums earned by line of business:			
Casualty reinsurance	305,678	275,708	72,394
Other specialty reinsurance	116,526	107,808	25,968
Property catastrophe reinsurance	11,421	12,540	5,115
Insurance programs and coinsurance	34,345	1,796	—
Total	467,970	397,852	103,477
Net premiums written by client location:			
United States	352,519	364,835	193,292
Bermuda	56,682	17,211	13,860
Europe	102,337	73,603	60,767
Asia and Pacific	2,583	10,353	6,411
Other	(333)	(43)	126
Total	513,788	465,959	274,456
Net premiums written by underwriting location			
United States	5,714	-	-
Europe	50,195	10,196	-
Bermuda	457,879	455,763	274,456
Total	513,788	465,959	274,456

Investment Performance

The components of our net investment income (loss) for the years ended 31 December 2016 and 2015 were as follows (in thousands):

	2016	2015
Interest income	\$ 122,378	\$ 94,619
Investment management fees	(19,554)	(17,405)
Other investment expenses	(13,006)	(4,356)
Net interest income	89,818	72,858
Net realized gains (losses)	(24,483)	1,753
Net unrealized gains (losses)	105,126	(83,090)
Investment performance fees	(24,065)	—
Net investment income (loss)	\$ 146,396	\$ (8,479)
Average net invested assets ⁽¹⁾	1,456,071	1,195,543
Net interest income return on average net invested assets	6.2%	6.1 %
Net investment income return on average net invested assets	10.1%	(0.7)%

(1) Average net invested assets are the average of total investments less revolving credit agreement borrowings over the reporting period.

The investment performance for 2016 is broken down into the following asset classes:

	Year Ended December 31, 2016			
	Net Interest Income	Net Unrealized Gains (Losses)	Net Realized Gains (Losses)	Net Investment Income
Net investment income (loss) by asset class:	<i>(\$ in thousands)</i>			
Term loan investments	\$ 66,018	\$ 60,825	\$ (15,298)	\$ 111,545
Fixed maturities	53,192	41,982	(1,422)	93,752
Short-term investments	2,441	1,278	(7,763)	(4,044)
Equities	—	1,041	—	1,041
Cash and cash equivalents	727	—	—	727
Investment management fees	(19,554)	—	—	(19,554)
Other investment expenses	(13,006)	—	—	(13,006)
Investment performance fees	—	—	—	(24,065)
	\$ 89,818	\$ 105,126	\$ (24,483)	\$ 146,396

Net investment income was \$146.4 million for the year ended 31 December 2016 compared to a net investment loss of \$8.5 million for the year ended 31 December 2015, an increase of \$154.9 million. The 2016 net investment return on average net invested assets was 10.1% as compared to (0.7)% for the prior year.

During the course of 2016, high yield bond credit spreads narrowed significantly resulting in a substantial improvement in Watford's unrealized gain (loss) position. In addition, 2016 net interest income benefited from an increase in the average net invested asset base. The net interest income return in 2016 was 6.2%, which was relatively unchanged from the prior period. The 2016 investment income gains noted above were partially offset by \$24.5 million of realized losses and \$24.1 million in performance fees payable.

Material Income & Expenses

The following table summarizes the Company's revenues and expenses for 2015 and 2016.

	Year End December 31,	
	2016	2015
Revenues		
Net premiums written	\$ 513,788	\$ 465,959
Change in unearned premiums	(45,818)	(68,107)
Net premiums earned	467,970	397,852
Other underwriting income	3,746	4,468
Net interest income	89,819	72,858
Realized and unrealized gain (loss) on investments	80,643	(81,337)
Investment performance fees	(24,065)	-
Total revenues	618,113	393,841
Expenses		
Loss and loss adjustment expenses	(321,581)	(277,659)
Acquisition expenses	(136,733)	(116,441)
Operating expenses	(17,890)	(11,830)
Net foreign exchange gain (loss)	4,893	(1,877)
Total expenses	(471,311)	(407,807)
Net income before income taxes	146,802	(13,966)
Income tax expense	(1)	-
Net income (loss) available to common shareholder	\$ 146,801	\$ (13,966)
Other comprehensive income (loss)		
Net foreign currency translation gain (loss)	(77)	(298)
Total comprehensive income (loss)	\$ 146,724	\$ (14,264)

OVERVIEW OF GROUP STRUCTURE AND BUSINESS

Board and Senior Executives

Watford maintains an effective system of governance, which provides for sound and prudent management of the integrated operations. Watford has designed its system of governance to achieve an adequately transparent organizational structure that has well-defined, clear, consistent and documented lines of responsibility across the company as well as ensuring personnel have the skills, knowledge and expertise necessary to properly discharge their assigned responsibilities. This allows Watford to establish and maintain processes to achieve effective internal reporting and communication of information at all relevant levels within the integrated operations.

Watford is managed under the direction of eight directors. The Board is responsible for ensuring that there is an appropriate business strategy, effective governance, appropriate financial resources and adequate internal controls. Reporting to the Board of Directors are the following committees:

- 1) Audit Committee
- 2) Compensation Committee
- 3) Investment Committee
- 4) Risk Committee
- 5) Strategy Committee
- 6) Underwriting Committee

Each committee has a charter which identifies the scope, authority and responsibilities of the committee.

Watford's Board and senior executives are outlined below:

John Rathgeber, Chief Executive Officer and Director. Mr. Rathgeber has served as Watford's Chief Executive Officer and as a director since January 2014. From October 2009 to January 2014, Mr. Rathgeber was Vice Chairman of the Arch Worldwide Reinsurance Group and Chairman of Arch Reinsurance Company. He served as President and Chief Executive Officer of Arch Reinsurance Company for eight years beginning with its formation in December 2001. Prior to joining Arch Reinsurance Company, Mr. Rathgeber was Executive Vice President of the Financial Solutions Business Unit of St. Paul Re, the reinsurance operation of the St. Paul Companies. From 1996 until 1998, he served as Senior Vice President in the Non-Traditional Underwriting Department of F&G Re Inc., the reinsurance operation of USF&G Corp., and from November 1992 until 1996, Mr. Rathgeber was Vice President of Non-Traditional reinsurance at F&G Re. Mr. Rathgeber started his career at Prudential Re, the reinsurance operation of The Prudential Insurance Company of America, in 1980 and worked there until 1992. During that time, he held various underwriting positions and was also a director in Prudential Re's Actuarial Department. He is a former Chairman of the Reinsurance Association of America and currently serves on its board of directors. Mr. Rathgeber received a B.A. from Williams College. He is a Chartered Property and Casualty Underwriter, a Fellow of the Casualty Actuarial Society and a Member of the American Academy of Actuaries.

Watford believes Mr. Rathgeber's qualifications to serve on Watford's board of directors include his many decades of insurance and reinsurance industry executive-level leadership and underwriting experience as well as his actuarial expertise.

Walter Harris, Chairman of the Board and Director. Mr. Harris has served as Watford's Chairman of the Board since March 2014. Since October 2014, Mr. Harris has been President and Chief Executive Officer of FOJP Service Corporation, a provider of insurance and risk management advisory services to major healthcare organizations, and President and Chief Executive Officer of Hospitals Insurance Company, Inc., a provider of medical professional liability insurance to physicians and hospitals. Before joining FOJP Service Corporation and Hospitals Insurance Company, Mr. Harris served as Senior Advisor and Vice Chairman Emeritus to Alliant Insurance Services, Inc., one of the largest insurance brokerage firms in the United States from December 2010 to May 2013. Prior to joining Alliant, he served as Chairman and Chief Executive Officer of T&H Group, one of the largest privately held insurance brokerage firms in the United States, from 1980 until its acquisition by Alliant in 2010. Mr. Harris has also served as

an advisor to investors in insurance entities as well as special counsel to several major insurance coverage litigations. He is currently a director of Loews Corp. and chairman of its audit committee. Mr. Harris received a B.A. from Stanford University, a J.D. from the University of California, Berkeley and an LLM in Taxation from the N.Y.U. School of Law.

Watford believes Mr. Harris's qualifications to serve on Watford's board of directors include his extensive background in the insurance industry, substantial board experience and his broad strategic and operational leadership.

Francois Chavel, Director. Mr. Chavel has served as a Watford director since March 2014. Mr. Chavel most recently served as Chairman and Chief Executive Officer of AXA America Corporate Solutions, the U.S. P&C insurance operation of AXA S.A., and its subsidiaries from February 2003 to February 2007. Mr. Chavel was responsible for winding down approximately \$2 billion of reinsurance/insurance liabilities after AXA S.A. decided to exit the reinsurance and P&C insurance businesses in the United States. Prior to his role at AXA, Mr. Chavel served as Director, President, Chief Executive Officer and Chairman of the Executive Committee of SOREMA N.A. Holding Group, which was the reinsurance arm of the largest mutual insurance group in France prior to its sale to SCOR Group, a French-based group of financial services companies, primarily focused on reinsurance, in 2001. Prior to SOREMA, Mr. Chavel served as Executive Vice President and Chief Operating Officer of SCOR US Corp, SCOR Group's provider of insurance and reinsurance in the United States, in addition to holding various other positions from 1973 until 1988. Mr. Chavel received an M.S. from École Supérieure des Travaux Publics in Paris, France.

Watford believes Mr. Chavel's qualifications to serve on Watford's board of directors include his broad and deep knowledge of the insurance and reinsurance industry, earned through many years of executive-level insurance and reinsurance industry leadership.

Nicolas Papadopoulos, Director. Mr. Papadopoulos has served as a Watford director since March 2014. Since July 2014, Mr. Papadopoulos has served as the Chief Executive Officer of Arch Reinsurance Group, an officer position of Arch Capital Group Ltd. Mr. Papadopoulos also serves as a member of Watford's strategy committee. Prior to July 2014, Mr. Papadopoulos served as President and Chief Executive Officer of Arch Reinsurance Ltd. since November 2005. Prior to November 2005, Mr. Papadopoulos served as chief underwriting officer of Arch Reinsurance Ltd. from October 2004. Mr. Papadopoulos joined Arch Reinsurance Ltd. in December 2001 as Senior Global Property Underwriter. Prior to joining Arch Reinsurance Ltd., he held various positions at Sorema N.A. Reinsurance Group, a U.S. subsidiary of Groupama S.A., a Paris-based global insurance group, from 1990, including Executive Vice President and Chief Underwriting Officer beginning in 1997. Prior to 1990, Mr. Papadopoulos was an insurance examiner with the Ministry of Finance, Insurance Department, in France. Mr. Papadopoulos graduated from École Polytechnique in France in 1986 and École Nationale de la Statistique et de l'Administration Économique in France with the French equivalent of a Ph.D. in 1989. He is also a member of the International Actuarial Association and a fellow at the French Actuarial Society.

Watford believes Mr. Papadopoulos's qualifications to serve on Watford's board of directors include his many years of executive-level reinsurance industry leadership, his deep insurance and reinsurance industry underwriting experience as well as his actuarial expertise.

Thomas Miller, Director. Mr. Miller has served as our director since May 2017. Mr. Miller retired from PricewaterhouseCoopers Bermuda in 2016, having been with the firm since 1984, where he served a wide variety of financial services and specifically insurance and reinsurance

company clients. He became a partner of Coopers & Lybrand in 1991 and was managing partner of the firm at the time of the merger with Price Waterhouse in 1998 and was joint managing partner of the merged PwC firm until 2003. Mr. Miller lives in Bermuda and has served on the boards of a number of Bermuda organizations including Bermuda Government's Audit Committee and The Bermuda Institute of Chartered Accountants. Mr. Miller obtained his professional designation as a Chartered Accountant in 1981. He received his Bachelor of Commerce from Queen's University, Kingston Ontario, and holds the professional designation of FCPA.

Watford believes Mr. Miller's qualifications to serve on our board of directors includes his extensive experience and expertise in public accounting for public and private financial services companies as well as his general business acumen.

Garth Lorimer Turner, Director. Mr. Lorimer Turner has served as a Watford director since March 2014. Mr. Lorimer Turner currently serves as Co-Founder and Director of Cohort Limited, a Bermuda company founded in July 2012 which provides corporate management and consultancy services to offshore companies and funds and acts as a Trading Member of the Bermuda Stock Exchange. From August 2001 to July 2012, Mr. Lorimer Turner served as Managing Director of Jupiter Asset Management (Bermuda) Limited, a wholly-owned subsidiary of Jupiter Fund Management Plc, a leading U.K. fund management group listed on the London Stock Exchange with products that range from unit trusts to investment companies and offshore funds. Mr. Lorimer Turner received an LL.B. from the University of Southampton, England and Law Society Finals from the College of Law at Lancaster Gate in London. Mr. Lorimer Turner is a qualified lawyer in England & Wales and Hong Kong and a Bermuda qualified barrister and attorney.

Watford believes Mr. Lorimer Turner's qualifications to serve on Watford's board of directors include his extensive experience in the investment and broader financial services industries and his general financial and business acumen, all of which have provided him with significant expertise relevant to Watford's business model which combines insurance and reinsurance underwriting with an investment strategy designed to complement Watford's target business mix.

Deborah DeCotis, Director. Ms. DeCotis has served as a Watford director since 2017. She is a retired Morgan Stanley Managing Director, and is active on various professional and philanthropic boards. Currently she serves as director on both Allianz Global Investors Capital LLC – Multi-Fund Board and the PIMCO Closed-End Funds Board. Her prior professional experience also includes being a director and member of the Audit and Governance Committee for Armor Holdings, a manufacturer of military-grade safety equipment. She served as Lead Director during the sale of Armor to BAE. Prior to Armor she was an executive vice-president for Sotheby Holdings, Inc. Outside of the professional realm she is a member of Circle Financial Group and the Council of Foreign Relations. She also recently ended her term as a trustee on the board of Stanford University, where she previously served on the Advisory Council of Stanford Business School and was trustee and Chair of the Stanford Business School Trust where she was a recipient of the John W. Gardner Volunteer Leadership Award. In addition, Ms. DeCotis recently completed her ten year term as co-Chair of the Special Projects Committee at Memorial Sloane Kettering Hospital, having served on that Committee for 28 years. Ms. DeCotis holds a BA in Mathematics from Smith College and an MBA from the Stanford Graduate School of Business, from which she graduated with distinction as a Miller Scholar (top 10% of the class).

Watford believes Ms. DeCotis' qualifications to serve on our board of directors include her many years of executive-level investment industry leadership, and her broad governance experience.

Marc Grandisson, Director. Mr. Grandisson has served as a Watford director since 2014. He has served as President and Chief Operating Officer of Arch Capital Group Ltd. since January 2016. Prior to that he was Chairman and Chief Executive Officer of Arch Worldwide Reinsurance and Mortgage Groups from February 2014. Prior to February 2014, he served as Chairman and Chief Executive Officer of Arch Worldwide Reinsurance Group, an officer position of Arch Capital Group Ltd., since November 2005. Mr. Grandisson also serves as a member of the Company's Executive Strategy Committee. Prior to November 2005, he served as President and Chief Executive Office of Arch Reinsurance Ltd. from February 2005. He served as President and Chief Operating Officer of Arch Reinsurance Ltd. from April 2004 to February 2005 and as Senior Vice President, Chief Underwriting Officer and Chief Actuary of Arch Reinsurance Ltd. from October 2001. From March 1999 until October 2001, Mr. Grandisson was employed as Vice President and actuary of the reinsurance division of Berkshire Hathaway. From July 1996 until February 1999, Mr. Grandisson was employed as Vice President-Director of F&G Re Inc. From July 1994 until July 1996, Mr. Grandisson was employed as an actuary for F&G Re. Prior to that Mr. Grandisson was employed as an actuarial assistant of Towers Watson. Mr. Grandisson holds an M.B.A. from The Wharton School of the University of Pennsylvania. He is also a Fellow of the Casualty Actuarial Society and a Member of the American Academy of Actuaries.

Watford believes Mr. Grandisson's qualifications to serve on our board of directors include his many years of executive-level reinsurance industry leadership, his broad and deep insurance and reinsurance industry underwriting experience and his actuarial expertise.

Robert Hawley, Chief Financial Officer. Mr. Hawley has served as Watford's Chief Financial Officer since July 2015. Mr. Hawley has over 20 years of professional experience in public accounting and reinsurance. Prior to joining Watford, he held the position of Vice President, Corporate Treasury Manager at XL Group Ltd. from January 2010 to July 2014. At XL Group Ltd., he was responsible for capital and collateral management, including debt capital market and credit facility transactions. From 2006 to 2009, Mr. Hawley worked at RenaissanceRe Holdings Ltd., Bermuda, as the Assistant Treasurer where his role included treasury, rating agency and investor relations management. From 2002 to 2006, he worked as Assistant Vice President, Account Executive at Marsh & McLennan Companies Inc., Bermuda and was responsible for management of several Fortune 500 captive insurance companies. Prior to that, Mr. Hawley was a Corporate Advisory Services Manager at KPMG LLP, London, Canada, from 1995 to 2002. Mr. Hawley is a Chartered Professional Accountant, Chartered Accountant and a member of the Chartered Professional Accountants of Ontario, Canada. Mr. Hawley received an Advanced Business Accounting Diploma from Fanshawe College, Ontario, Canada.

Jon Levy, Chief Risk Officer. Mr. Levy has served as Watford's Chief Risk Officer since March 2014. Mr. Levy has over 19 years of insurance experience, most recently with Endurance Specialty Holdings Ltd. (now Sampo International), where he worked from July 2008 to March 2014, most recently serving as Senior Vice President and Chief Pricing Actuary of Global Insurance. His prior roles within Endurance include Chief Pricing Actuary of Bermuda Insurance, after joining Endurance in 2008 as its Corporate Actuary. Prior to Endurance, Mr. Levy was a Senior Consultant at Tillinghast (now Willis Towers Watson) in Philadelphia where he provided consulting services for domestic and international insurers and reinsurers, as well as asbestos and pollution liability analyses for corporate and insurance clients. Prior to Tillinghast, Mr. Levy spent five years with ACE INA in Philadelphia, including three years in its run-off claims division, Brandywine Holdings. Mr. Levy holds an A.B. from Lafayette College. He is also a Fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries.

Laurence B. Richardson, II, Chief Operating Officer. Mr. Richardson has served as Watford's chief operating officer since January 2017. From March 2012 to January 2017, he held the position of Senior Vice President – Capital Markets at Arch Capital Group Ltd., where he primarily focused on convergence transactions through which reinsurance risk is transferred to capital markets investors. In such capacity, Mr. Richardson was involved in the formation and launch of Watford. Mr. Richardson was seconded to Watford by Arch Capital Group Ltd. from July 2016 to January 2017. Prior to joining Arch Capital Group Ltd., Mr. Richardson held the position of Senior Vice President in the Ventures Group at RenaissanceRe, which develops and structures non-traditional reinsurance products, makes strategic investments and creates and manages RenaissanceRe's joint ventures and other managed vehicles, including Top Layer Re, DaVinci Re, Timicuan Re, Starbound Re-I, Starbound Re-II and Channel Re. Mr. Richardson had joined RenaissanceRe in mid-2001. Prior to joining RenaissanceRe, Mr. Richardson was an investment banker with over 15 years of experience in the structured products and securitization arena, having been employed at a number of nationally recognized Wall Street firms, including the investment banks of E. F. Hutton & Co., Donaldson, Lufkin & Jenrette Securities Corporation, and Alex Brown & Sons, Incorporated and prior thereto was an attorney with the law firm Thacher, Proffitt & Wood LLP. Mr. Richardson graduated from the University of Virginia with both B.S. and J.D. degrees.

Alexandre Scherer, Chief Executive Officer of WSIC and WIC. Alexandre Scherer is the head of Watford's insurance operations and has served as the President and Chief Executive Officer of WSIC and WIC since September 2015 and August 2016, respectively. Mr. Scherer has over 23 years of experience in the insurance and reinsurance industry, including 11 years with AXA Insurance Company, a subsidiary of AXA S.A., of which he served eight years as President, Chief Executive Officer and director, as well as three years as Executive Vice President and Chief Operating Officer. Mr. Scherer also served as President and Chief Executive Officer, as well as Executive Vice President and Chief Operating Officer, of AXA Liabilities Managers, Inc., a subsidiary of AXA S.A. specializing in non-life insurance and reinsurance legacy business acquisition and management. Prior to that, he served as Vice President, Alternative Risk Transfer Underwriter, as well as Risk Manager, at AXA Reinsurance Company. Mr. Scherer also served as Second Vice President of Sorema North America and Underwriter and Head of Alternative Risk Transfer of Sorema SA. Mr. Scherer holds a degree of Diplome d'Ingenieur from École Centrale Paris in France. He is a Qualified Actuary from the French Actuaries Institute (France) and a Member of the American Academy of Actuaries.

Remuneration

When Watford established its remuneration programs, consideration was given to whether such programs align the interests of Watford's directors and officers with those of Watford's shareholders and whether such programs encourage unnecessary or excessive risk taking. Annual cash bonus awards focus on achievement of annual goals as well as both corporate performance measures and the executive officer's individual performance and are at the discretion of the compensation committee. Watford believes its compensation philosophy and programs encourage employees to strive to achieve both short- and long-term goals that are important to Watford's success and building shareholder value, without promoting unnecessary or excessive risk taking. Watford reviews its compensation policies and practices periodically to determine whether such policies and practices are appropriate in light of Watford's risk management objectives.

Directors

During the year ended 31 December 2016, the Company paid cash retainers to Mr. Chavel, Mr. Turner and Mr. Harris for their service as members of the board of directors and any committees thereof. The Company also paid a cash retainer to Margaret Cannella, who served as a Watford director until she passed away in November 2016. The Company did not pay any compensation to Ms. DeCotis or Tom Miller as they were not appointed as directors until 2017. Watford did not pay any cash or equity compensation to Mr. Rathgeber as a director, as he is compensated as an employee of the Company. Watford also did not pay Mr. Papadopoulo or Mr. Grandisson any cash or equity compensation during the year ended 31 December 2016. All directors were reimbursed for reasonable out-of-pocket expenses incurred for their service as members of the Board of Directors and any committees of the Board of Directors.

Executives

For the year ended 31 December 2016, Watford's executive officers were paid a base salary, an annual performance-based bonus which varies with the individuals' performance, and pension and other benefits. Such amounts are approved by the Compensation Committee.

Watford offers a tax-qualified 401(k) plan to all employees (including the named executive officers) for retirement savings. Under this plan, employees are allowed to defer and invest up to 100% of their cash earnings, subject to the maximum 401(k) contribution amount. Contributions can be invested in a diversified selection of mutual funds. In order to encourage participation and to provide a retirement planning benefit to employees, Watford also provides a discretionary profit sharing contribution of 4% of an employees' eligible compensation, provided that profit share contributions are limited to the lesser of 4% of an employee's compensation or, in 2016, \$9,000. All new employee contributions are fully vested immediately upon entry to the plan. Watford currently does not have any additional supplementary pension or early retirement schemes for members of the Board or executives.

Material transactions with shareholder controllers

Arch Reinsurance Ltd. ("ARL") is party to certain quota share agreements with one or more of Watford's operating subsidiaries and also owns approximately 11% of the outstanding common shares of WHL as of 31 December 2016.

Risk Management and Solvency Self-Assessment

The following narrative provides an overview of the Company's Risk Management Framework ("Framework"), which describes the Company's methodology for identifying, measuring, and reporting on the key risks affecting Watford. It outlines our approach to risk identification and assessment, and how risk management is implemented and integrated into the organizational structure of the business.

Description of Risk Management Process

Watford has developed its Framework and Risk Register to identify and assess the material risks faced by the Company. Watford has produced an enterprise-wide risk assessment which detailed all of the significant risks facing the company. This risk assessment was performed at the highest levels of the company and involved input from the Board and senior management.

Watford's Framework and Risk Register lists the risks faced by Watford, as well as current and planned controls being implemented. The Framework documents Watford's Corporate Governance, Risk Management, and Material Risks.

The Risk Register has been developed to identify and assess the material risks faced by Watford in more granular detail than the Framework. This register contains the following:

- The Board Committee ultimately responsible for the risk
- The Risk Owner for each Risk
- A list of monitoring procedures for each risk, if applicable
- A list of mitigation procedures for each risk, if applicable
- A list of risk control procedures for each risk, if applicable

The rating of each risk is derived from an assessment of likelihood and impact. This assessment is made at both an inherent level and after consideration of Watford's control environment, including mitigation techniques and controls in place at service providers.

The Risk Register is a key input into the risk management regime, and any material changes in the underlying risks will be modelled for potential impact upon Watford's capital requirements. Such changes include, but are not limited to, changes in business mix, strategy and investment policy. The rating of risks is considered by management on at least an annual basis and the rating for the most significant risks is presented to the Company's Risk Committee and Board of Directors.

The controls identified in the Risk Register to monitor, mitigate and control the risks facing Watford are reviewed for continued relevance and documented in the process documents for each function. Compliance with the components of these controls is verified via the ongoing management reviews and Internal Audit reviews undertaken at Watford. This is undertaken on a group-wide basis and any issues are reported to the Watford board.

The Board of Directors have reviewed and formally approved the Risk Register, as well as provided input in the scoring of the risks faced by Watford. Working with the Board, Watford have established Risk Appetites for each material risk. Watford has put into place procedures for risk measurement, mitigation, and controls, as well as monitoring compliance with the Board set Risk Appetite.

Watford's Risk Management Function is led by its Chief Risk Officer whom is a member of the Executive Management team. The Function performs regular risk reporting to the Board each quarter. The Board assesses the risk and control effectiveness of the Function.

Implementation and Integration of Solvency Self-Assessment

Watford has built business processes that provide a forward looking analysis of our risks and capital management. Watford analyzes its exposure to adverse underwriting and investment scenarios on a regular basis. These tests help Watford quantify the magnitude of capital required under stressed scenarios.

Watford's Solvency Self-Assessment process includes:

A quarterly estimate of single name concentrations within the underwriting portfolio, a quarterly estimate of the PMLs, quarterly estimates of Underwriting Stress scenarios, as well as annual estimates of various Lloyd's Realistic Disaster Scenarios ("RDS").

- Stress tests of its investment portfolio under historical and hypothetical periods of investment market turmoil, and the effects on Watford's liquidity position
- An annual planning analysis of our underwriting and investment activities, with quarterly reforecasts presented to the Board. Watford has utilized the internal models calibrated to rating agency and regulatory requirements as part of our assessment of the capital requirements of our proposed business plans, and measures its projected forward looking capital adequacy and liquidity position in historical and hypothetical stressed scenarios.

Watford's annual plan is prepared by the Company's senior and is approved by the Board of Directors after review of the results of these solvency assessments.

Currently, the amount of capital required to cover our material risks is assessed through regulatory capital requirements, rating agency models, internally developed stress tests, internally developed default and recovery analysis for our credit investments, internally developed liquidity models and stress tests, and underwriting realistic disaster scenarios.

The risk management framework is designed to help Watford set a coherent risk management strategy and to enhance the likelihood of meeting its strategy. This framework has therefore been designed with the following objectives:

- Identify all significant risks assumed by Watford through its business, internal processes and relevant external environment.
- Measure identified risks on a consistent basis.
- Establish a set of responses to manage risks within the stated risk appetite and tolerances.
- Establish the principles by which Watford can evaluate the risk/reward trade-offs associated with key strategic and tactical decisions.
- Ensure return on capital goals are met through the efficient use and allocation of capital.
- Provide a regular assessment of Watford's solvency and liquidity through the use of quantitative metrics, including stress and scenario testing.

Internal Controls

Watford maintains an effective internal control system, which includes administrative and accounting procedures, an internal control framework, appropriate reporting arrangements and a compliance function.

The Board is responsible for monitoring the establishment and maintenance of the system of controls used to assess and manage exposure to all areas of risk. The objectives of these controls are to ensure that Watford's risk strategy is maintained and risk remains within the appetite and tolerances set by the Board.

As part of Watford's business model, many of the day-to-day operations are outsourced to third party service providers and the internal control environment has been structured to appropriately address the risks related to this business model. For more detail on the services outsourced, refer to the Outsourcing section below. All relevant controls in place at Watford's outsourced service providers have been included in Watford's Risk and Control Matrices to provide management oversight of all activities. Watford places reliance on controls that exist at the relevant third party providers and as such relies heavily on the internal audit function described below to review controls performed at these entities and perform on-site visits as required.

Watford's Compliance Function is led by our Chief Operating Officer. The function has established a compliance program to ensure compliance with all relevant laws, legislation, regulations and guidance. The purpose of Compliance is to assist the Board in achieving its overall strategic objectives by promoting a culture of integrity, ethical conduct and compliance with the laws, regulations and administrative provisions that affect Watford. The compliance function also is responsible for the ongoing assessment of any possible impact of changes in the legal environment on our operations and for the identification and assessment of Legal / Litigation risk and for monitoring adherence to certain elements of the risk management framework and reporting thereon to the appropriate forums

The WHL Board has approved the establishment of a compliance and ethics program to ensure that all companies within the group promote an organizational culture that encourages the highest standards of ethical business conduct and compliance with the Group's Code of Business Conduct, policy statements and any laws and regulations which govern the Company's business activities (collectively referred to as the "Compliance Program"). The Compliance Program is intended to ensure that all companies within the group exercise appropriate due diligence to prevent conduct which is in violation of its Compliance Program, thereby protecting the Group's reputation and good name.

The requirements of the compliance program apply to all employees, officers and directors of the Company and, where appropriate, to agents of the Company.

Internal Audit

Watford employs the services of an outside provider for Internal Audit services. The Company has outsourced its Internal Audit function to a third party who, along with their internal processes to ensure independence from the Company, has direct access to the Audit Committee, agree the audit plan with the Audit Committee, and provide findings reports from each audit for discussion at the Audit Committee. Audit's primary objective is to work with management to identify and address risks relating to processes integral to the achievement of business objectives. The function serves as an independent and objective source of appraisal and assurance within Watford to support management, the Audit Committee and the Board of Directors in discharging their responsibilities. The Internal Audit function has direct and frequent communication with the Audit Committee where any issues identified are raised.

Internal Audit also assists management, the Audit Committee and the Board of Directors in evaluating the appropriateness and effectiveness of business processes, internal controls and the governance and risk management functions. Internal Audit also identifies process improvements, including those resulting from a changing operating environment and will make recommendations to management.

Internal Audit performs special examinations at the request of management, the Board and the Audit Committee.

Internal Audit performs a risk assessment ahead of each year to ensure that its work is focused on the key risks and how effectively management mitigates these risks. Internal Audit evaluates all significant functions and bases its Annual Plan on a risk-based approach. As such, Internal Audit has sufficient knowledge and experience to provide insight into the effectiveness of the risk management system and is a key input into the system of internal control.

The Board of Directors has final responsibility, with delegation to the Audit Committee in the areas noted above. In respect of compliance with stated risk tolerances, the risk management function has responsibility for the identification and reporting of non-compliance, with much of the detailed work to review the effectiveness of risk controls delegated to the internal audit function, as well as through the reporting by the compliance function at key service providers.

Identification of risks as they relate to compliance with jurisdictional laws, regulations, policies and procedures, together with the appropriateness of the response to any risks identified, is a responsibility of the Chief Operating Officer.

Actuarial Function

The Watford Actuarial function is responsible for:

- Performing loss liability estimates, including assessing the quality of underlying data
- Assisting in the execution of the risk management framework.
- Performing actuarial pricing analyses on assumed underwriting risks
- Provide support of financial information to the regulatory authorities

The actuarial function is split between Watford and Arch as outlined in the Services Agreements. As part of the underwriting process, Arch actuaries are involved in the pricing of individual contracts. Procedures and controls surrounding these pricing mechanisms at Arch are reviewed by Watford.

Also as part of the Service Agreements, Arch actuaries provide loss and LAE liability reserve recommendations on a contract by contract basis. These reserve recommendations are derived from the same policies and procedures that Arch utilizes for its own portfolio.

Watford has employed an external third party actuarial firm to provide an independent loss reserve review on a quarterly basis and serve as the appointed loss reserve specialist for annual regulatory filings in Bermuda and the United States.

The Actuarial Function is comprised of experienced individuals with in-depth knowledge of, and professional qualifications, in actuarial and financial mathematics. The actuarial function is structured appropriately given the nature, scale and complexity of the risks inherent in the company's operations. This allows Watford to have a robust process for setting loss reserves, leveraging the established processes and procedures employed by Arch, making our own analyses and judgments, and through periodic reviews by external actuarial firms.

Outsourcing

Watford maintains a lean management team, and works closely with outsourced serviced providers to achieve our strategic goals. We outsource significant elements of our business to third party service providers. Key outsourced services include the following:

- Investment management services
- Investment accounting services
- Underwriting management services
- Internal Audit

For our underwriting operations, Arch provides underwriting services including sourcing and evaluating underwriting opportunities, claims-handling, loss control, exposure management, portfolio management and modeling, as well as statistical, actuarial, and administrative support services, in each case, subject to Watford's underwriting and operational guidelines and the oversight of Watford's senior management and Board of Directors. In regard to our investments, HPS manages Watford's non-investment grade portfolio while Arch Investment Managers ("AIM") manages the investment grade portfolio, subject to Watford's investment guidelines and the oversight of the senior management and Board of Directors.

Watford outsource these functions in order to cost-effectively leverage the expertise and strong market positions of these trusted partners. Through Watford's association with Arch, we benefit from Arch's worldwide platform on a variable cost basis, thus avoiding the fixed expense of maintaining a multi-line platform for our underwriting operations. Similarly, we believe that the structure of the compensation we pay to HPS and AIM provides benefits to us both in terms of cost-effective access to the expertise required to execute our investment strategy and in aligning interests.

Management ensures that any outsourced responsibilities are delegated and managed appropriately, with ultimate responsibility resting with the Watford Board.

Watford Internal Audit performs reviews of these controls on a regular basis to confirm that outsourced providers are acting as expected.

SECTION B – RISK PROFILE

Overview

Watford's risk appetite framework provides an expression of the level of risk the Company is willing to accept in pursuit of its strategic objectives. The risk appetite framework provides quantitative and qualitative statements which are used to define the general attitude within the organization towards the desired level of risk. It not only supports the Company's risk management framework, it also enables us to make informed business decisions having regard to the key risks to which it may be exposed by such a decision.

Underwriting Risk

Underwriting risk comprises Pricing Risk, Reserve Risk and Catastrophe Risk and manifests itself as the risk of loss, or adverse change in the value of insurance liabilities, due to inadequate pricing and/or loss-provisioning assumptions.

Pricing risk is defined as the risk that premiums plus any investment income earned thereon are not sufficient to cover losses when they come due in the future. If a contract is incorrectly priced at inception, then the total amount of revenue Watford ultimately collects related to that contract may not be sufficient to cover emerging claims.

Reserving risk is defined as the risk that loss reserves set aside by Watford in respect of insurance claims (whether actual reported or potential future claims) will not be sufficient to fully cover the ultimate claim amounts, and includes the risk of loss from the uncertainty around the timing of the claims payments.

Catastrophic risk is the risk of loss from infrequent, high-severity claims from natural or man-made disasters.

Watford understands the importance of proper pricing controls, risk selection, exposure monitoring and claims management in order reduce the underwriting risk to an acceptable level.

The Underwriting Committee and the Board retain overall responsibility to maintain adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing exposure to Underwriting Risk. The Board has delegated oversight of underwriting risk controls and day-to-day management of these risk controls to Arch. The Chief Risk Officer has been assigned the responsibility of monitoring Underwriting Risk.

The Company measures, manages, and reports on its Underwriting Risk in the following ways:

- Arch employs its established underwriting, pricing, and risk management procedures for the Watford portfolio on the same basis as it does for its own portfolio
- Watford and Arch have agreed a set of guidelines ("Underwriting Guidelines") pursuant to which Underwriting Risk is to be managed. The Underwriting Guidelines are monitored and reviewed continuously to ensure compliance with Watford's objectives and risk tolerances set out therein

- As part of the Services Agreement between Arch and Watford, there is regular reporting of individual bound contracts, Probable Maximum Losses for Property Catastrophe Exposures, Realistic Disaster Scenarios, and other data points.
- The Company conducts quarterly loss liability reviews reflecting the input from the Arch reserving process, our 3rd party actuarial firm, as well as our own analyses
- The Company measures and monitors the underwriting results utilizing its own procedures including risk aggregation, Watford specific underwriting stressed scenarios, and actual performance relative to expectations

Watford Internal Audit reviews and tests the controls in place at Arch and Watford in order to confirm their operational effectiveness. Watford management also maintains detailed Risk and Control Matrices to identify the population of controls in place at Arch and Watford.

Investment Risk

Investment risk manifests itself as the risk of investment returns being lower than Watford's investment return targets, either through reduced market valuations of the investment assets or reduced income/yield from our investments, or a combination of the two factors, which is known as "total return". Ultimately, a failure of the total return from our investment portfolio might result in the inability to pay claims to policyholders. An assumed level of investment total return is a meaningful component in the original pricing of each contract and also in the estimation of the level of loss reserves necessary to cover expected future losses, and a shortfall in investment return (versus expectations) would have an adverse effect on Watford's results and potentially its ability to meet its obligations when they become due.

In addition, the risk of default (credit risk) of individual investments is an investment risk to which Watford is subject. Credit risk can arise from borrowers suffering business or financial stress, from increased debt service costs due to rising interest rates and many other factors.

In addition, the risk of default (credit risk) of investments is treated as an investment risk given the impact that widening credit spreads, obligor defaults and company failure can have on the investment portfolio. The risk of default of Watford's reinsurers is considered in a further section of this framework. Watford considers the implication of investment credit risk when evaluating concentration risk.

The Investment Committee and the Board retain overall responsibility to maintain adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing exposure to Investment Risk. The Board has delegated oversight of investment risk controls and day-to-day management of these risk controls to HPS. The Chief Risk Officer has been assigned the responsibility of monitoring Investment Risk.

The Company measures, manages, and reports on its Investment Risk in the following ways:

- Watford and its Investment Managers have agreed a set of guidelines ("Investment Guidelines") pursuant to which Investment Risk is to be managed. The Investment Guidelines are monitored and reviewed continuously seeking to ensure compliance with Watford's investment objectives and risk tolerances set out therein.

- Watford’s Investment Manager’s employ their own established risk management procedures on the behalf of the Watford portfolio
- There is regular reporting to Watford by its Investment Managers on the performance, material positions and risk profile of the portfolios
- The Company regularly measures and monitors its Investment Risk across the enterprise including stress testing its market, credit, and liquidity risk as it relates to its investments

Watford Internal Audit reviews and tests the controls in place at HPS and Watford in order to confirm their operational effectiveness. Watford management also maintains detailed Risk and Control Matrices to identify the population of controls in place at HPS and Watford.

Liquidity Risk

Liquidity Risk is the risk that Watford is unable to liquidate/sell investments at or near market value in a timely fashion in order to settle financial obligations as they come due. Watford views its liquidity risk across four dimensions:

- Funding Liquidity Risk – the risk that Watford will be unable to meet cash, asset, margin, and collateral requirements of counterparties
- Asset Liquidity Risk – the risk that Watford will not be able to execute a transaction at the prevailing market price because there is temporarily no demand for the deal
- Market Risk – the risk that changes in financial market prices and rates will reduce the value of an asset or liability
- Reserve Risk – Reserving risk is defined as the risk that reserves set in financial statements in respect of insurance claims are not sufficient to fully cover the claim amounts, and includes the risk of loss from the uncertainty around the timing of the claims payments

The Risk Committee and the Board retain overall responsibility to maintain adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing exposure to Liquidity Risk. The Board has delegated oversight of the risk controls and day-to-day management of these risk controls to Arch and HPS. The Chief Risk Officer has been assigned the responsibility of monitoring Liquidity Risk.

As part of its risk management program, Watford assess its liquidity position as it related to assets, liabilities, and collateral on a quarterly basis. This monitoring includes stressing the asset, liability, and both portfolios simultaneously.

Credit Risk

Watford considers credit risk in terms of the risk of default of insureds/reinsurers and reinsurance intermediaries. Credit risk of the investment portfolio is considered as an Investment, Liquidity, and Market Risk. As such Credit Risk relates to the risk of loss, or adverse change in financial condition, resulting from fluctuations in the credit standing of insureds and reinsurers.

Any change in the credit standing of Watford's insureds and reinsurers potentially affects the value of premiums receivable and reinsurance recoverable.

The Risk Committee and the Board retain overall responsibility to maintain adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing exposure to Credit Risk. The Board has delegated oversight of the risk controls and day-to-day management of these risk controls to Arch. The Chief Risk Officer has been assigned the responsibility of monitoring Credit Risk.

As part of the service agreement between Arch and Watford, Arch provides administrative services for the direct business, retroceded business from Arch entities, and any outward reinsurance purchased by Watford. A key monitoring procedure performed by Arch with respect to credit risk is an aged receivable report, which measures and tracks the magnitude and age of outstanding balances due to Watford by its cedents. In addition, Watford monitors its own outward reinsurance recoverable on a quarterly basis as part of its Risk Management Report.

At 31 December 2016 the majority of reinsurance recoverables for paid and unpaid losses were due from ARL which has a rating of A+ from A.M. Best Company.

Operational Risk

Operational risk presents itself as the risk of a loss from inadequate or failed internal processes, or from personnel and systems, or from external events. Watford also includes in Operational Risk the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of business activities.

Risk Committee and the Board retain overall responsibility to maintain adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing exposure to Operational Risk. The Chief Risk Officer has been assigned the responsibility of monitoring Operational Risk.

Key business and systems processes are documented by Watford to confirm understanding. These processes include procedures around Human Resources, Business Processes, Information Systems, Fraud, and Insurance Distribution.

Reputational Risk

We view Reputational Risk across four dimensions:

- Internal Reputational Risk – the Company suffers adverse impact due to negative publicity or perception of the Company due to its own acts
- Service Provider Reputational Risk – the Company suffers adverse impact due to negative publicity, perception, of its material business partners
- Rating Agency Risk – the company fails to understand the rating methodologies, does not execute its business plan, or otherwise fails to mitigate a risk in another area resulting in a negative watch or downgrade

- Regulatory Risk – the company fails to understand and comply with the legislative requirements or otherwise fails to mitigate a risk in another area resulting in a loss of its insurance license.

In attempting to manage reputational risk, the Risk Management Framework has been established to ensure that adverse impacts on Watford's reputation or credibility are appropriately monitored, controlled and mitigated.

Through our Risk Management process, we seek to avoid harming our brand and market credibility, our rating agency relationships, and our regulatory relationships.

The CEO and the Board are responsible for managing the firm's reputational risk. The Audit Committee and the Board retain overall responsibility to maintain adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing exposure to Reputational Risk.

Watford has regularly scheduled calls with rating agencies, regularly scheduled meetings with its Regulatory Authorities, and regularly scheduled meetings with its material service providers,.

Risk Mitigation in the Organization

Watford has developed a number of mitigation actions as discussed under each risk identified above. Mitigation strategies include the oversight of strategic partners in Watford's outsourced business model and rigorous review of the compliance with agreed upon guidelines. Watford's internal audit function will also review controls and escalate issues to the Audit Committee as required.

Material Risk Concentrations

Under Watford's internal underwriting policy, it is required that management ensures there is no exposure to unreasonable risk concentrations. In conjunction with the contract reviews, the CRO collates and maintains data sufficient to assess the common risk drivers and monitor concentrations of risk. The Risk Management Report also contains a summary of the portfolio against the concentration limits and recommendations for any actions to be taken.

Investment in Assets in Accordance With the Prudent Person Principles of the Code of Conduct

Watford's portfolios are invested pursuant to investment guidelines formulated to complement the underwriting portfolio. We pursue a diversified insurance portfolio with a focus on medium and long tail casualty lines of business. The investment guidelines are monitored and reviewed continuously to ensure compliance with the investment objectives and risk tolerances outlined therein.

Stress Testing

Watford analyzes its exposure to adverse underwriting and investment scenarios on a regular basis. These tests help Watford quantify the magnitude of capital required under stressed scenarios. Our Risk Management processes include a quarterly estimate of single name concentrations within the underwriting portfolio, a quarterly estimate of the PMLs, a quarterly estimate of Watford specific underwriting stressed scenarios, as well as annual estimates of

various Lloyd's RDS scenarios. For investments, stress tests are performed on the results of the capital models on the pro-forma company utilizing our budgeting analysis to ensure that risk in the investment portfolio is within internal tolerances. These stress tests focus on mark-to-market volatility in the investment portfolio. Additionally, we stress test our investment portfolio by estimating the valuation under both historical and hypothetical periods of investment market turmoil. These stress tests are presented to the Board on a quarterly basis. The results of our capital planning and stress scenario tests are important components of our management process.

Based upon these stress tests, the Company believes that it has sufficient capital and liquidity to comply with the contractual obligations of the organization and regulatory requirements upon experiencing losses within its risk tolerances.

SECTION C – SOLVENCY VALUATION

Valuation Bases, Assumptions and Methods to Derive the Value of Each Asset Class

The Company has used the valuation principles outlined by Bermuda Monetary Authority's "Guidance Note for Statutory Reporting Regime" for the reporting period's statutory filing. The economic valuation principles outlined in this document are to measure assets and liabilities on a fair value basis (which is the value that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between open market participants at the measurement date). The fair value principles used for the assets are as follows:

Cash and Cash Equivalents – includes cash time deposits and investments maturing within three months. The fair value of these holdings is determined by using mark to market valuation, or quoted market prices in active markets for similar assets with adjustments to reflect differences if mark to market valuation is not possible, or mark to model valuation otherwise.

Fixed Income Securities – are valued in accordance with mark to market principles where possible or quoted market prices in active markets for similar assets with adjustments to reflect differences if mark to market valuation is not possible. For fixed income securities that are not actively traded and for which similar assets are also not actively traded, the Company uses its investment managers and/or pricing services to prepare inputs to assist the Company with mark to model valuations.

Equities and investment funds - includes common stock and preferred shares and are valued using the quoted market prices.

Accounts Receivable and Premium Receivable – are recorded at a fair value and balances due in more than one year have been discounted at the relevant risk free rate.

Derivative instruments- are valued at quoted market prices. In the absence of an active market, prices are based on observable market inputs.

Valuation Bases, Assumptions and Methods to Derive the Value of Technical Provisions

Insurance technical provisions are valued based on best estimate cash flows, adjusted to reflect the time value of money using a risk-free discount rate term structure with an appropriate illiquidity adjustment. In addition, there is a risk margin to reflect the uncertainty contained inherent in the underlying cash flows which is calculated using the cost of capital approach and a risk-free discount rate term structure. The discount rate term structures are prescribed by the Bermuda Monetary Authority for each reporting period.

The best estimate for the loss and loss expense provision is calculated by using United States Generally Accepted Accounting Principles (US GAAP) reserves as the starting point and then performing a series of adjustments:

- Removal of prudence margins
- Incorporation of expected reinsurance counterparty defaults
- Incorporation of events not in data (ENID)
- Other adjustments related to consideration for investment expenses.

- Discounting of cash flows

The best estimate for the premium provision is calculated by using the unearned premium reserve on a US GAAP basis, adjusting for bound but not incepted business as at 31st December 2016 and applying expected future loss ratios, expense ratios and appropriate claims pay-out patterns to derive cash flows which are then discounted.

At 31st December 2016, the total Technical Provisions amounted to \$448,690,705 comprising of the following:

Net premium provisions	\$ (103,044,341)
Net loss and loss expense provisions	476,525,905
Risk margin	75,209,141
Total general business insurance technical provisions	<u>\$ 448,690,705</u>

Description of Recoverable from Reinsurance Contracts

Recoverables from reinsurance contracts are based on principles similar to the gross best estimate and include reinstatement premiums required to be paid to the reinsurer, and expenses in relation to the management and administration of reinsurance claims. The balance is adjusted for counterparty credit rating based on rating agency and experience default statistics. Through reinsurance agreements with Arch and other 3rd party reinsurers, Watford cedes a portion of its premiums. At 31 December 2016 the majority of reinsurance recoverables for paid and unpaid losses were due from ARL which has a rating of A+ from A.M. Best Company.

Valuation Bases, Assumptions and Methods to Derive the Value of Other Liabilities

Similar to the valuation principles for assets, the Company's liabilities follow the valuations principles outlined by Bermuda Monetary Authority's "Guidance Note for Statutory Reporting Regime" which values liabilities at a fair value basis. All other liabilities are valued on a US GAAP basis and settlements not expected to be settled within a year are discounted using the prescribed discount rates provided by the Bermuda Monetary Authority as at 31st December 2016.

SECTION E – CAPITAL MANAGEMENT

Capital Management Policy

The primary capital management objectives of the Company are to maintain a strong capital base to support the development of its business and to meet regulatory and rating agency capital requirements at all times. The Company strives to be efficient and prudent user of capital, maintaining target capital levels at or above those required for an “A” rating from A.M. Best, and above requirements of our insurance regulators.

In addition to the common shares and contingently-redeemable preference shares we issued, we have arranged credit facilities to support our business operations. We believe that we hold sufficient capital to allow us to take advantage of market opportunities and to maintain our financial strength ratings, as well as to comply with all applicable statutory regulations.

We monitor our capital adequacy on a regular basis and will seek to adjust our capital base (up or down) according to the needs of our business. As part of our capital management program, we may seek to raise additional capital or may seek to return capital to our shareholders through share repurchases, cash dividends or other methods (or a combination of such methods). Any such determination will be at the discretion of our board of directors and will be dependent upon our profits, financial requirements and other factors, including legal restrictions, rating agency requirements and such other factors as our board of directors deems relevant.

There have been no material changes to capital during the reporting period.

At December 31, 2016 the Company’s Eligible Capital was categorized as follows:

Tier	Applied to Minimum Margin of Solvency	Applied to Enhanced Capital Requirement
Tier 1	833,669,327	833,669,327
Tier 2	57,071,828	57,071,828
Tier 3	0	0
Total	890,741,154	890,741,154

Tier 1 capital consists of capital stock, contributed surplus and statutory surplus.

Tier 2 capital consists mainly of the excess of encumbered assets vs liabilities.

Confirmation of Eligible Capital That is Subject to Transitional Arrangements

Not applicable

Identification of Any Factors Affecting Encumbrances on Capital

Watford utilizes letters of credit and trust accounts to meet collateral requirements and therefore is required to maintain assets on deposit to support its insurance and reinsurance obligations.

Additionally, Watford maintains assets on deposit with various regulatory authorities to support our insurance business.

Identification of Ancillary Capital Instruments Approved by the Authority

Not applicable

Identification of Differences in Shareholder's Equity as Stated in the Financial Statements Versus the Available Capital and Surplus

The following is a reconciliation of US GAAP shareholders' equity to statutory capital and surplus as of December 31, 2016:

Total US GAAP Shareholders' Equity	\$	1,177,605,537
Non-admitted assets		(13,016,341)
Statutory Capital and Surplus	\$	<u>1,164,589,196</u>

ECR and MSM Requirements at the End of the Reporting Period

At December 31, 2016 the Company's regulatory capital requirements were assessed as follows:

Minimum Margin of Solvency: \$252,701,307

Enhanced Capital Requirement: \$517,486,100

The Company was compliant with the MSM and ECR requirement at the end of the reporting period.

A Description of the Amount and Circumstances Surrounding the Non-Compliance, the Remedial Measures and Their Effectiveness

Not applicable.

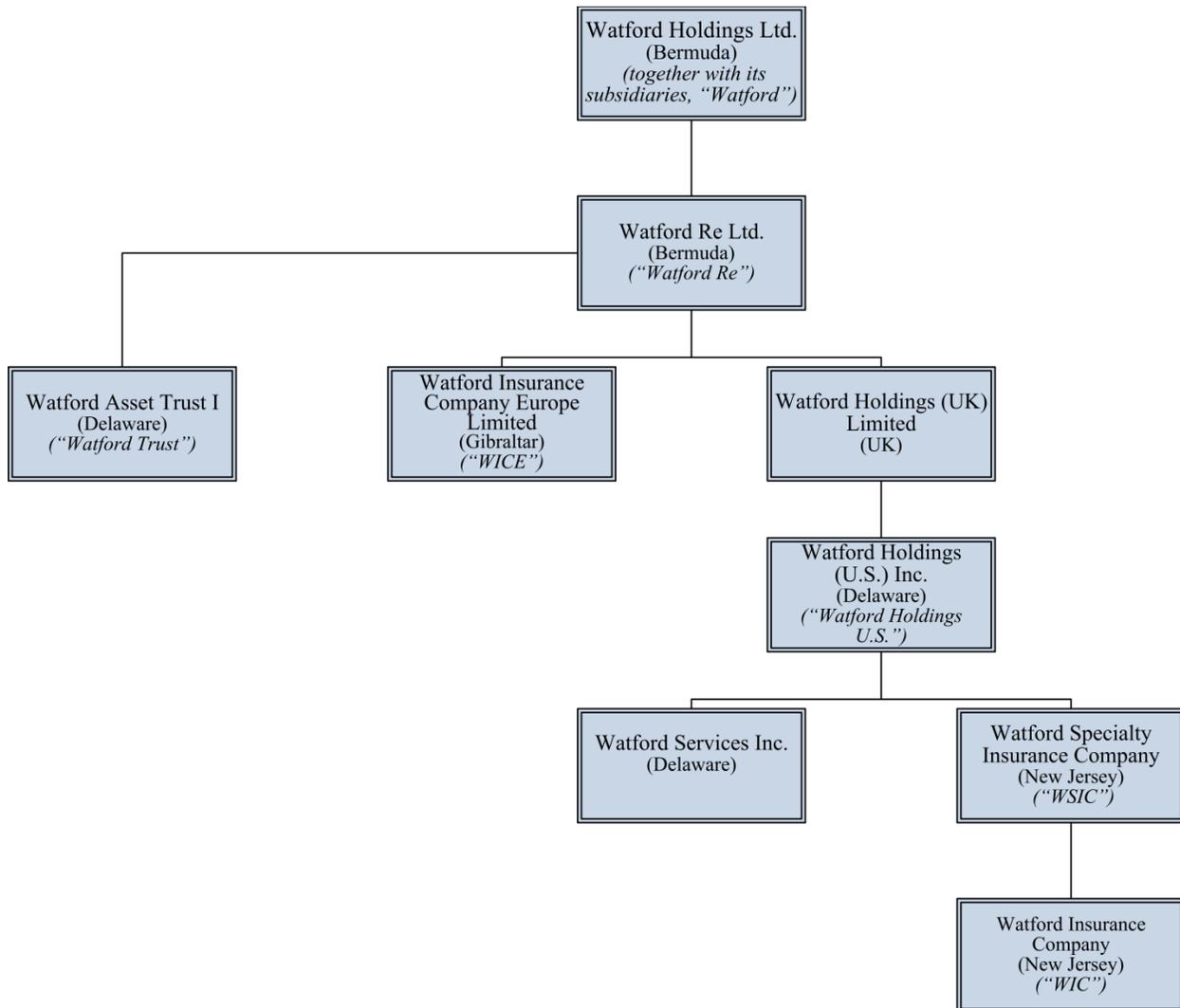
Where the Non-Compliance is not Resolved, a Description of the Amount of the Non-Compliance

Not applicable.

Approved Internal Capital Model

Not applicable as the Company has not applied to have its internal capital model approved to determine regulatory capital requirements.

SECTION D – APPENDIX 1 – CORPORATE STRUCTURE





Watford Re

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To the best of our knowledge and belief, the Financial Condition Report represents the financial condition of Watford Re Ltd. In all material respects.

John Rathgeber
Chief Executive Officer

Jon Levy
Chief Risk Officer