72.1%
Combined ratio

27.5%
Loss ratio

10.9%
Return on equity*

* RoE excluding the impact of warrants in 2015 was 13.5%

INTERVIEW WITH ALEX MALONEY

Good underwriting remains paramount, as does our ability to act quickly and nimbly to changing conditions and our preparedness to closely match our capital to the opportunities available.

Q | *What have the challenges been in 2015?*

Having worked in the insurance business for the last 25 years it is my view that 2015 has been the most challenging calendar year for the whole insurance industry that we have seen for at least a decade. The insurance industry as a whole has seen a further accumulation of capital; this stems from yet another benign year for catastrophe losses, resulting in pressure on premium pricing and the terms and conditions of coverage. Several insurers have been involved in merger and acquisition activity, which is in part a response to falling margins and the perceived need amongst some of our competitors to rationalise their larger and more complex operations and infrastructures. The broking community has not been immune to these pressures and has continued both to consolidate its operations and to innovate with new products and methods of distribution, which might be regarded as having been designed to generate new income streams for the brokers themselves, rather than serving the insurance needs of the market. Into this mix must be added the continuing commercial pressure on our clients, particularly in the oil and gas industries, where the dramatic fall in the oil price has resulted in less exploration and development activity, as well as economic pressure on our clients' existing operations and asset prices and a corresponding drop-off in the demand for insurance coverage. Whilst our return on equity is 10.9 per cent, the warrant adjusted return on equity of 13.5 per cent is a better reflection of our underwriting results. This, together with our combined ratio of 72.1 per cent for the year, demonstrates our ability as a business to pick our team and adapt our game plan to these harsh playing conditions. Against this backdrop I am delighted with our financial performance.

Q | *How has the business responded to the difficult market?*

Our strategic priorities are engrained within our own business and people and are also now well understood by our investors and stakeholders. Good underwriting (our basic skill set) remains paramount, as does our ability to act quickly and nimbly to changing conditions and our preparedness to closely match our capital to the opportunities available. Our global headcount remains less than 200, which means that as a business we remain able to avoid the cost and complexity of our larger competitors and to adapt our risk profile to market conditions. In a market where the price for assuming risk has been falling, we have reduced our risk levels. This takes discipline. We have had to take hard decisions to turn down badly-priced business and we have reduced our inwards exposures where required. On the bright side, the reduction in the pricing of risk has created excellent opportunities on the reinsurance purchasing side. This combination of inwards underwriting discipline and better priced and broader outwards reinsurance coverage has enabled us to de-risk our overall portfolio. Our Cathedral business, which we acquired during 2013, has helped give strength and breadth to the core business of the Group. Its contribution to Group profits of $46.0 million and its impressive combined ratio of 73.6 per cent for the year illustrate the quality and discipline which have always been characteristic of our Group. The year on year decline in our net premium income is not an exciting story to tell, but it is the mark of a business which adapts its strategy so as to flex its capital and risk profile to deliver a solid risk adjusted return to its shareholders. A more detailed analysis of market conditions can be found in the Underwriting Review on pages 28 to 29.

Q | *Does Lancashire have the size to remain relevant to clients and brokers?*

There has been a tendency amongst commentators and analysts to equate the "relevance" of an insurance company to the size of its capital base. That is a superficially attractive argument, but it is flawed. Whilst the balance sheet size of an insurer is important, it is not the only factor in the decision of brokers and clients when placing insurance risks. Our brokers come to us, whether that be through our London or Bermuda Lancashire platforms, through Cathedral at Lloyd's, or through Kinesis, because we employ leading specialty underwriters in the fields in which we underwrite. Our underwriters understand the needs of the brokers and our clients and have the standing and ability to act as leaders in the negotiation of pricing and coverage terms and to service with excellence the ongoing needs of our clients. We may not always be the cheapest, or have the biggest balance sheet, but you get what you pay for and we do pride ourselves on being the leaders in those classes within which we operate. As a Group we do not wish to create a worldwide network. We have a strong presence in the London and Bermuda markets and we are supportive of those markets and the related broker distribution networks, which we consider to be world-leading in their capabilities and expertise. Our priority is to maintain a tightly focused and relatively small business without the distractions and overheads of multiple foreign offices and operations. Lancashire is a business which prides itself on its underwriting expertise, its excellence of service and its ability to adapt its capital base to the opportunities in any given market. I have recently met with all of our largest shareholders and I am confident that they understand the challenges of the current market and our strategic response, which ensures our continuing relevance to our clients, our brokers and all our stakeholders.

Q | *You have chosen a rugby theme for this Annual Report – why is that?*

Rugby has been a lifelong love for me. I have enjoyed the game both as a player and as a supporter. It is the ultimate team sport and a game in which success, whilst drawing on individual talent, is ultimately built on teamwork. That is how I see our Group. As a team we value the contribution of all the members, and I hope that we encourage a culture where we are not reliant on one or two star signings, but on a bench strength of home grown talent. We also place value on clear and rapid communication, a prime example of that being Lancashire's daily underwriting call where all our Lancashire underwriters, however experienced, have the opportunity to consider all the risks being evaluated by our business – whether in London or Bermuda. Any team has to adapt rapidly, to play the pitch, weather conditions and the particular strengths and weaknesses of any opponent as they are found. The challenges of the current insurance market dictate to us as a business that we modify our game plan to the conditions of play. As with any good team, we assess the relative risks and rewards and we consider when to adopt a defensive strategy and when to attack. From time to time we may suffer setbacks, but our objective is to create a business capable of succeeding year upon year, whatever challenges we may face.

Q | *How do you think the market will change during 2016?*

The fundamentals of our business don't change. The market is driven by the forces of supply and demand and, absent a major market moving catastrophe loss event, I anticipate that there will continue to be an oversupply of underwriting capacity across the industry in 2016. Generating returns will remain difficult in this soft part of the cycle. As a Group we will continue to adapt to these market conditions, but I am suspicious of some of the recent innovations in the market, including broker facilities, the rapid growth in cyber coverage pursued by some of our competitors and the use of disruptive technologies to create new platforms for distribution. All of these have their associated risks and my gut instinct is to proceed with extreme caution and to focus on our traditional skills. So for 2016 we will work to provide an acceptable return on our investors' capital, driven by our view of risk and capital requirements in response to market conditions.

Q | *Where do you see the business in the longer term?*

Our Group has the structure and expertise to implement our current nimble strategy as a bespoke provider of specialty insurance and reinsurance. We have carefully and consistently developed this strategy since Lancashire's inception in 2005. My vision is to continue to build the best bespoke specialty (re)insurance company in the world by retaining and recruiting best in breed underwriters across a number of specialty insurance and reinsurance classes. Over the next few years we will look to consolidate our existing core book of business and to grow organically other specialty lines, but only where the right opportunities present themselves. We will continue to optimise the use of our different underwriting platforms at Lloyd's, in London and Bermuda and through Kinesis, our third-party capital facility. We plan to keep the headcount small, maintaining a tight control over business costs. Perhaps most importantly, I want to build and consolidate a group of talented people with individual expertise and a strong sense of their place in the overall Lancashire team and a shared understanding of our strategic goals.

> Our underwriters understand the needs of the brokers and our clients and have the standing and ability to act as leaders in the negotiation of pricing and coverage terms and to service with excellence the ongoing needs of our clients.

In closing, I must mention Martin Thomas, our Chairman, who is stepping down at this year's AGM having served the Group for over nine years. I have enjoyed working with Martin and I have valued his support and insight – as well as his constructive challenge. Martin has been an excellent Chairman and member of the LHL Board and has helped guide our Board and business through both challenging and exciting times to establish Lancashire as one of the most successful and respected specialty insurance and reinsurance groups listed on the LSE. We will continue to work together until the 2016 AGM, when I will look forward to working with Peter Clarke, an existing member of our Board and the designated new Chairman. But I would like to take this opportunity to thank Martin for his exceptional contribution to the success of Lancashire.

Alex Maloney
Group Chief Executive Officer

INTRODUCTION TO STRATEGY

Over our ten year history our strategic objectives have remained unchanged. How we implement that strategy adapts as the market forces to which we find ourselves subject on the field of play ebb and flow. By adopting this active fluidity of approach we demonstrate the importance of one of the three cornerstones of our strategy: to operate nimbly through the cycle.

The market we find ourselves in today is a very different one from when we started ten years ago. In all of our lines of business, rates have declined and margins are under more pressure than at any time in our history. In order to effectively balance risk and return our approach is different over time. In very simple terms we get paid less now than in prior years for assuming the same risk – so we therefore adjust our risk levels down accordingly. We have consolidated our core portfolio of business and defended this book whilst at the same time protecting the balance sheet with broader and deeper reinsurance coverage. This year we have continued to manage down the volatility within the Group's underwriting portfolio as margins reduce. We still accept risk, as this is what we do. But we carefully manage the risk levels we accept, to reflect the market we see.

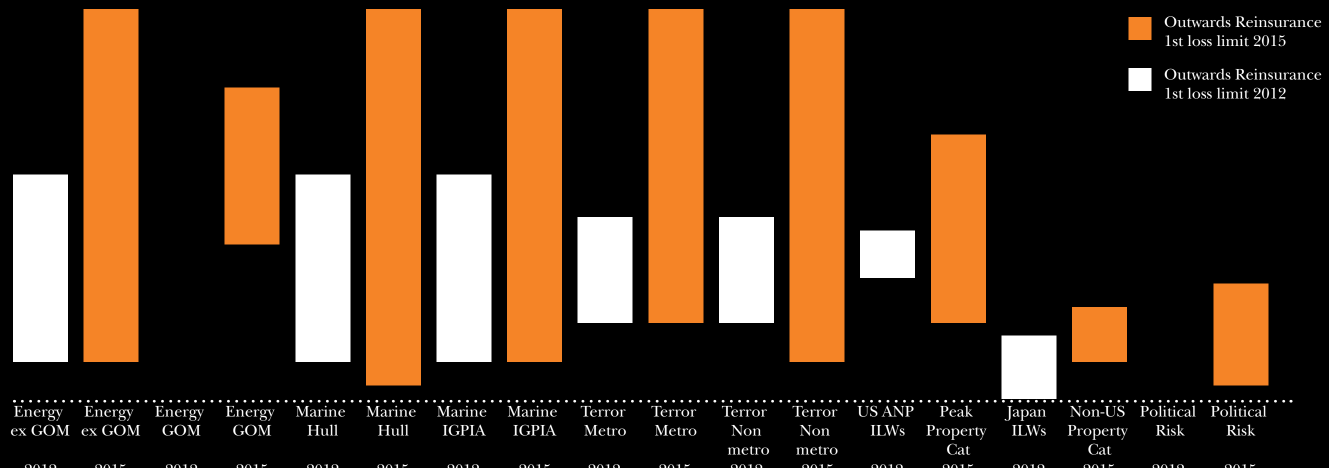
In soft markets premiums inevitably come under pressure. Even maintaining constant risk levels will deliver lower premium volumes as rates soften. In these markets there is a natural tendency to lose sight of basic underwriting principles and focus on premium income rather than underwriting profitability. To maintain underwriting discipline you need to accept that premiums will shrink. We believe that, ultimately, underwriting profitability should remain the focus. Why write more risk when the return for that risk is less? This can seem counterintuitive given the obvious but superficial attraction of maintaining premium levels. Our team of underwriters shares this view of the importance of careful risk selection rather than top-line growth and our principal focus is on generating underwriting profit. This sharp strategic focus is demonstrated by a combined ratio of 72.1 per cent. At Lancashire, underwriting always comes first.

Another temptation when premiums are reducing is to enter markets or underwrite products that are new and fashionable. Again, we tend not to be swayed by fashion. If we can understand the risk, or bring in best in breed underwriting teams that understand the risk, then we will expand the business. What we will not do is enter new classes purely to replace lost revenue across other areas of the portfolio.

It is fair to describe our underwriting strategy in this market as defensive. We feel that a defensive strategy is the correct one, and we are fortunate to have a portfolio of business with long-term blue chip clients that allows us to take this stance. We are very grateful for the support that both our clients and brokers have shown to the Group over the past year and throughout our ten year history, and we look forward to working with them for another ten years and beyond.

We wait patiently for the time when the market is in a more favourable position than it is today. In the meantime we will do everything we can to capitalise on the expertise and relationships we as a business have nurtured and to make sure the Group is best positioned for when these better times return.

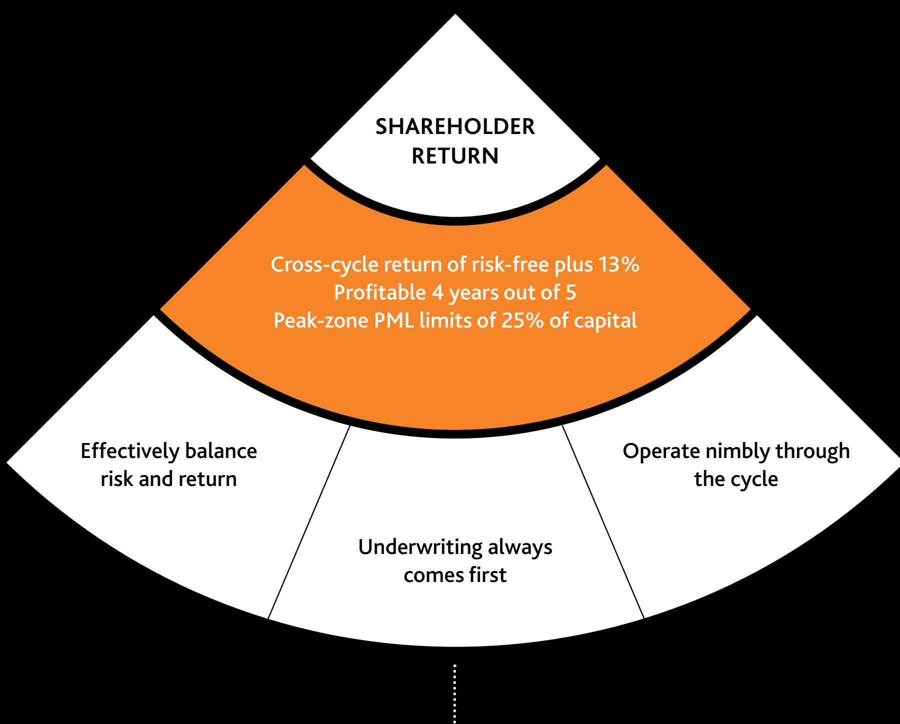
LANCASHIRE FIRST LOSS XL LIMIT ILLUSTRATION 2012 VS 2015



CONSISTENCY IN STRATEGIC DIRECTION OVER TIME

Our strategy

We have three strategic aims that enable us to meet our goal of providing an attractive risk-adjusted return to our shareholders. We put underwriting at the forefront of all that we do, we focus on getting the right balance between risk and return and we ensure that we can react nimbly to an ever-changing market. This enables us to serve our clients and brokers with significant capacity across the cycle, not just in the core business we aim to renew every year, but also in times or in areas where capacity is scarce: the opportunistic part of our portfolio. We keep our structure lean and overheads under strict control so that we can refocus our resources quickly. And we test our assumptions and performance constantly through our structure using daily underwriting calls or exception reporting to management, a fortnightly Risk and Return Committee meeting with all disciplines within the Group represented, and a series of supporting underwriting, operational, compliance, investment and finance committees. Around this our risk function and internal audit supply challenge and assurance to management and the Board through a simple and continuous reporting process.



OUR CULTURE – THE BEDROCK OF OUR STRATEGY

Lancashire encourages a culture of co-operation and respect based on open challenge. This can be seen clearly in the LICL and LUK daily underwriting call where senior and junior underwriters debate the risks they want to write and their fit to the portfolio and market. It also characterises the Group-wide Risk and Return Committee which brings together underwriting, actuarial, finance and treasury and risk to challenge the assumptions used in all areas of our planning and measuring the business.

Description

UNDERWRITING ALWAYS COMES FIRST

We employ 34 underwriters across the Group, many of them with decades of experience, and supply them with analytical tools to assess which business best fits our portfolios. We look for profitable new opportunities helping us to remain relevant to our brokers and clients.

EFFECTIVELY BALANCE RISK AND RETURN

By bringing together all our disciplines – underwriting, actuarial, modeling, finance, treasury, risk and operations – at our fortnightly RRC meetings, we are able to look at how different parts of our operations are working together. We stress test our business plans and gauge where we can be most effective without undue volatility.

OPERATE NIMBLY THROUGH THE CYCLE

As capital continues to accumulate in the (re)insurance market, the need to be nimble is more important than ever. This means being ready to deploy capital quickly when it is needed, and having the discipline to return it when it is not.

Achievements in 2015	*Performance*		*Associated strategic risks*
We have reduced our written premium and PMLs by turning down under-priced business, whilst retaining our core book. We have grown the number of Kinesis investors to ten and the number of cedants to ten, whilst deploying $299.5 million of limits.	**Combined Ratio** KPI 72.1% Still a leading combined ratio, even in difficult markets, evidencing the continued focus on underwriting, portfolio construction and superior risk selection.	**Gross premiums written** $641.1m We saw a significant contribution from Cathedral in 2015 as we focused on protecting our core portfolios, but maintained the discipline to decline or re-structure our participation on under-priced or poorly performing business.	The key risk in the current market phase is the loss of relevance to brokers and clients; with so much surplus capacity, insurers need to have a unique selling point. For Lancashire that is found in its mixture of capacity, leadership capability, significant reinsurance expenditure and multiple balance sheet options.
We have had to reduce income in some areas of our business in response to market weakening. But we have been able to find substantial outwards reinsurance opportunities that allow us to mitigate some of the effects of price reductions, and reduce our net exposures until the time is right for us to retain more risk.	**Return on Equity*** KPI 10.9% A good result despite a challenging market and the incidence of risk losses, helped by our improved outwards reinsurance programme. * RoE excluding the impact of warrants in 2015 was 13.5%.	**Probable Maximum Loss** $198.7m* We continued to reduce our exposure to key catastrophe perils as the market has become more competitive, demonstrating our discipline and nimbleness. * 1 in 100 year Gulf of Mexico Hurricane expected net loss at 1 January 2016.	The key issue for Lancashire is to continue to serve our clients and brokers with significant capacity, whilst ensuring that the portfolio is not unbalanced. This means constantly re-assessing our business mix, and testing key risk assumptions.
Lancashire renewed its 15 per cent disapplication of pre-emption rights to smooth potential future capital raises.	**Percentage of comprehensive income returned to shareholders** KPI 187.0% Lancashire continues to exercise the discipline of giving back capital it cannot profitably deploy, but remains open to new opportunities such as those developed in Syndicate 3010. *Page 26* KPIs	**Dividend Yield** 17.3% Whilst buying back shares can be a part of right-sizing capital, special dividends allow Lancashire to make substantial capital returns quickly when justified.	Lancashire has developed an expectation among its stakeholders that it will produce a consistent return and pay ordinary dividends and special dividends when it makes sense to do so. Lancashire has to ensure that all stakeholders understand that in hard markets Lancashire will want to retain and even raise capital to take full advantage of underwriting opportunities. *Page 39* Enterprise Risk Management