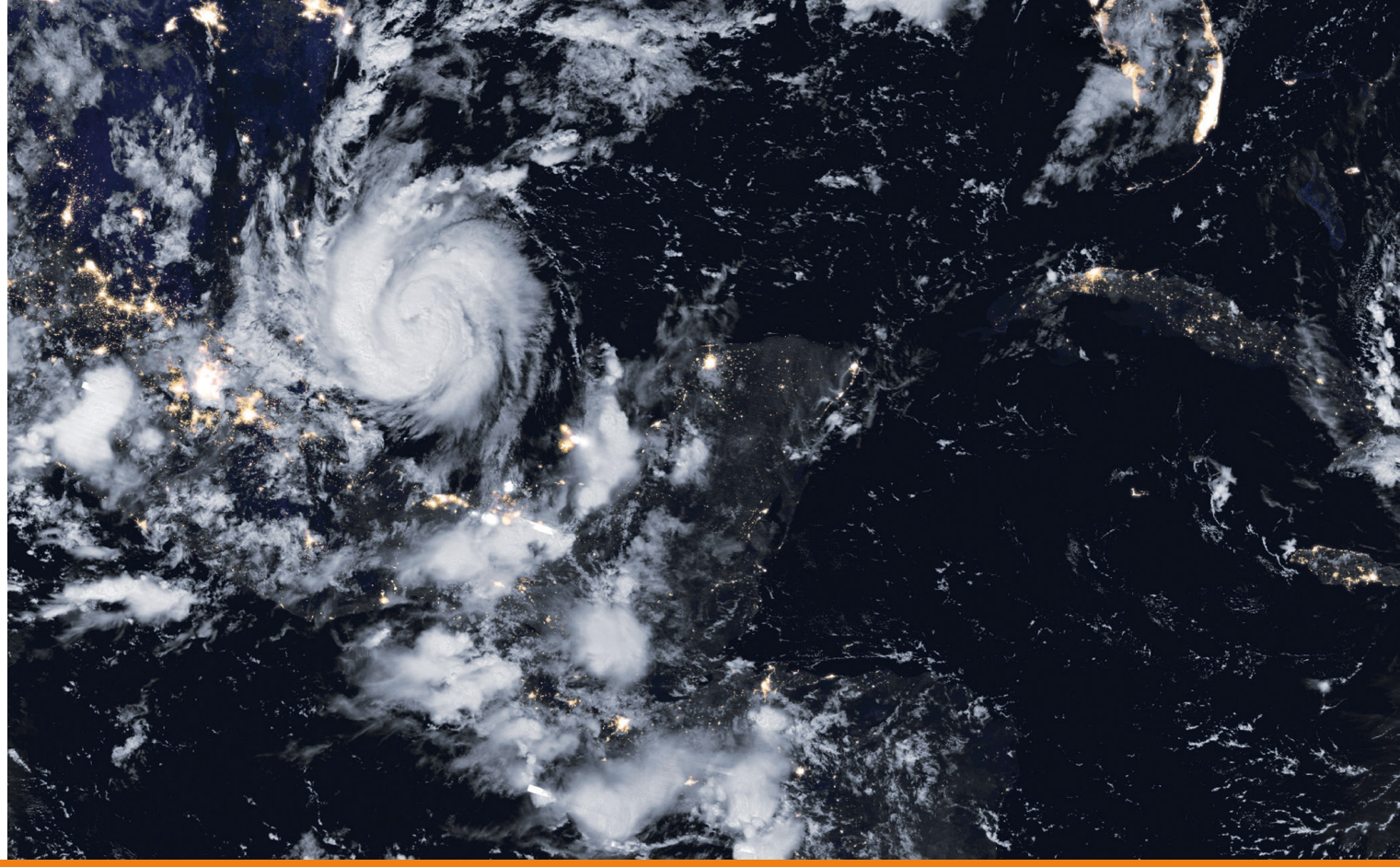
lancashire
HOLDINGS LIMITED

Responsive in every environment

Annual Report & Accounts 2017



Strategic report

Governance

Consolidated Financial Statements

Return on equity (KPI)

-5.9%
(2016: 13.5%)

Combined ratio (KPI)

124.9%
(2016: 76.5%)

(Loss) Profit after tax

$-71.1m
(2016: $153.8m)

Total investment return (KPI)

2.5%
(2016: 2.1%)

Dividend yield (KPI)

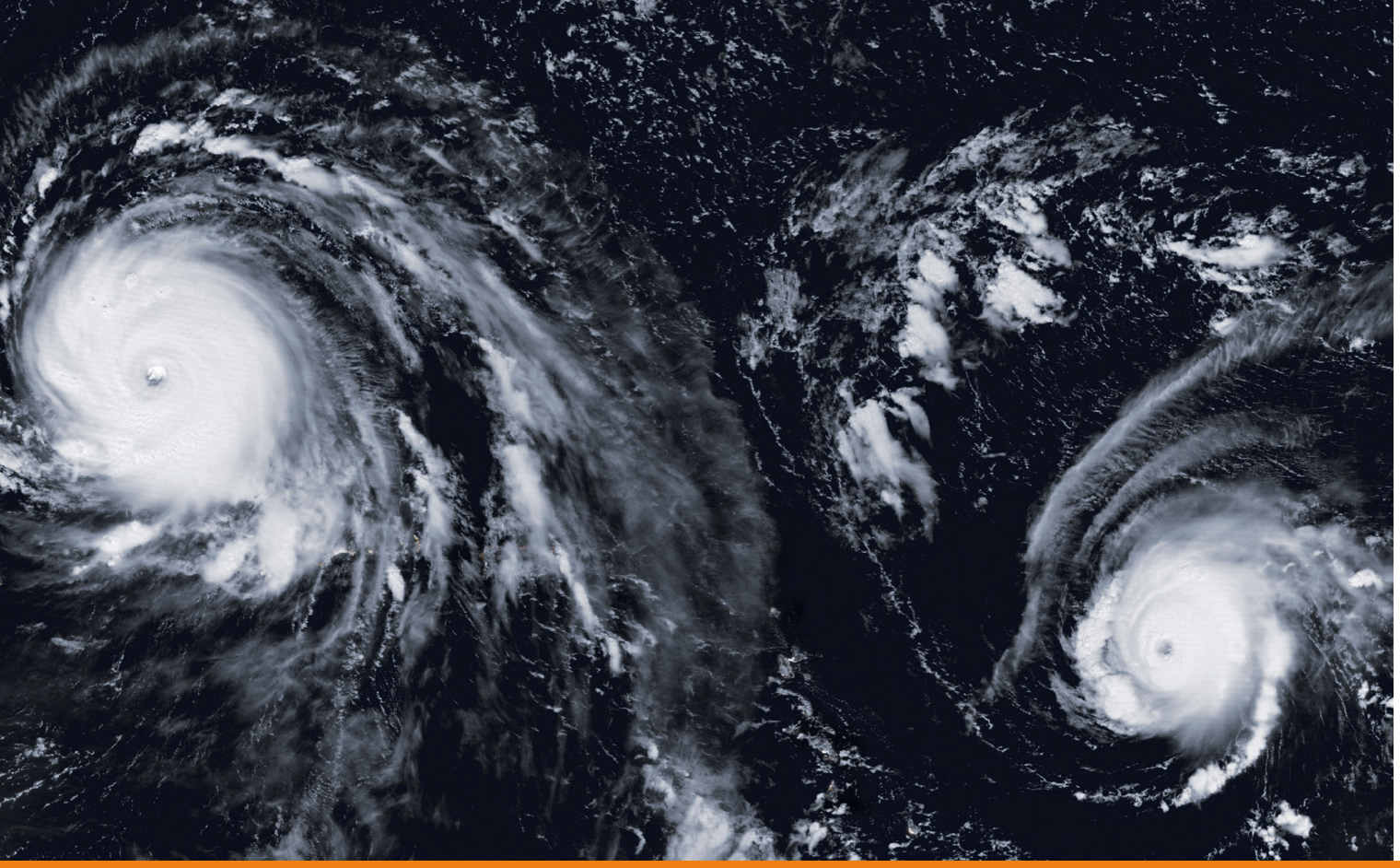
1.6%
(2016: 10.5%)

Total shareholder return (KPI)

9.4%
(2016: 2.4%)

	Return on equity	Combined ratio	(Loss) Profit after tax	Total investment return	Dividend yield	Total shareholder return
2017	-5.9	124.9	-71.1	2.5	1.6	9.4
2016	13.5	76.5	153.8	2.1	10.5	2.4
2015	13.5*	72.1	181.1	0.7	17.3	25.9
2014	14.7*	68.7	229.3	1.0	17.8	-24.2
2013	18.9*	70.2	222.5	0.3	12.3	21.3

* RoE including the impact of warrants was 10.9% in 2015, 13.9% in 2014 and 18.9% in 2013.



The consistency and adaptability of our core principles enable us to deliver strong returns across the market cycle.

Whatever conditions the market brings, we are disciplined in the risks that we underwrite and manage, staying nimble to seize opportunities wherever they present themselves.

Lancashire is a provider of global specialty insurance and reinsurance products operating in Bermuda and London across three platforms: rated company, Lloyd's and collateralised security.

The Group focuses on short-tail, mostly specialty (re)insurance risks under five general segments: Property, Energy, Marine, Aviation and Lloyd's.

Please refer to our glossary on pages 153 to 156 for key definitions.

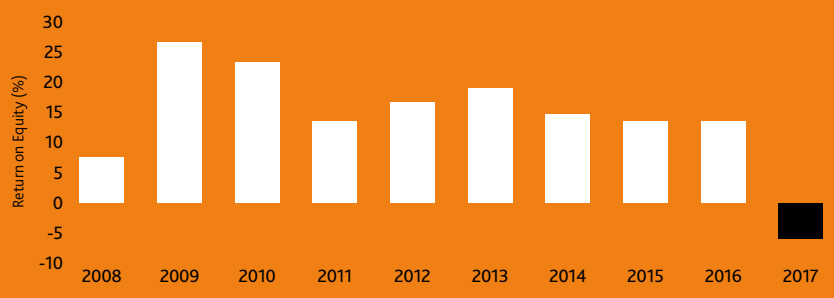
NASA Earth Observatory images by Joshua Stevens and Jesse Allen, using VIIRS day-night band data from the Suomi National Polar-orbiting Partnership and Terra MODIS data from the Land Atmosphere Near real-time Capability for EOS (LANCE)

2017 has proven to be a challenging year but no matter what environment we find ourselves in, underwriting comes first. This focus on our core principle has allowed us to deliver sector-leading returns across the cycle.

We are guided by our core strategic principles

Delivering superior returns across the cycle and moderating downside risk

Ten-year Return on Equity[1]



Description

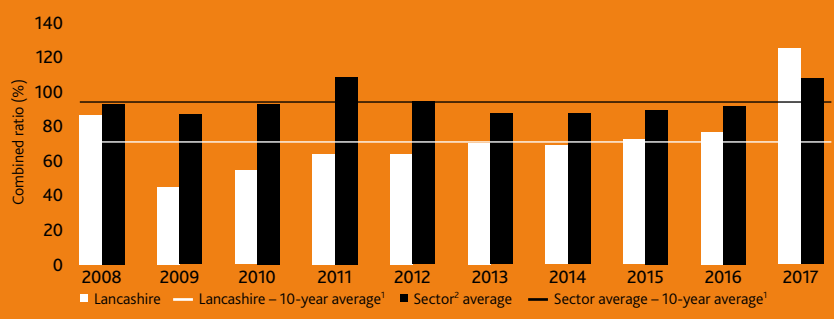
Our strategy is designed to cope with hard and soft markets, managing capital and exposures to maximise risk-adjusted returns across the cycle whilst moderating our exposures according to market conditions.

Our strategic cross-cycle aim is to be profitable four years out of five, acknowledging there will be years when we incur losses. 2017 is the first full year we have incurred a loss since inception.

(1) RoE excluding the impact of warrants.

Experienced underwriters produce higher returns across the cycle

Ten-year combined ratio



Description

Group management and our underwriters have decades of experience in rated companies, Lloyd's and collateralised security markets. Across the cycle our combined ratio outperformed the sector average.

(1) Ten-year average based on 2008 to 2017 reporting periods. Lancashire ratios weighted by annual net premiums earned. Annual sector ratios are weighted by annual net premiums earned.
(2) Sector includes Arch, Argo, Aspen, Axis, Beazley, Everest, Hanover, Hiscox, RenaissanceRe, Validus and XL Catlin. The 2017 result for Hiscox is not available at the time of the report.

Source: Company reports.

This year has shown why it is critical to balance risk and return and to understand the implications of over exposure in the market. The comprehensive risk management procedures our teams undertake every day allow us to strike the right balance of risk and return. In particular, we expect volatility in the occurrence of the catastrophe events to which our products respond.

We navigate risk confidently

Managing our exposures across segments and geographies

Gross premiums written by class and region

Property	33.5%
Energy	17.2%
Marine	11.4%
Aviation	2.9%
Lloyd's	35.0%

U.S. and Canada	30.0%
Worldwide offshore	27.5%
Worldwide, including the U.S. and Canada	16.7%
Europe	6.6%
Far East	4.7%
Worldwide, excluding the U.S. and Canada	1.9%
Middle East	1.2%
Rest of the world	11.4%

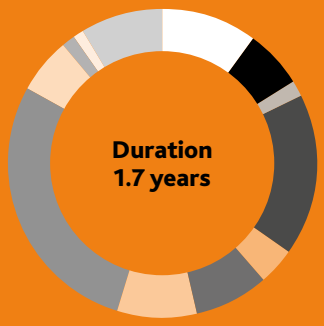
Description

A well-diversified portfolio across multiple lines and geographies operates as a base to trade across the cycle.

During 2017, Lancashire has balanced the needs of its shareholders, wider stakeholders and importantly met the needs of its clients following the impact of the multiple catastrophe events.

Protecting our assets

Investment asset allocation



Cash	10.2%
Short-term investments	6.0%
Fixed maturity funds	1.7%
Government debt	17.0%
Agency debt	3.8%
Agency MBS, CMBS	7.7%
Non-agency RMBS, ABS, CMBS	8.5%
Corporate bonds	28.2%
Bank loans	5.8%
Fixed maturity – at FVTPL	1.4%
Equity securities	1.3%
Hedge funds – at FVTPL	8.4%

Total portfolio at 31 December 2017 $1,842.7m
Credit quality AA-.

Description

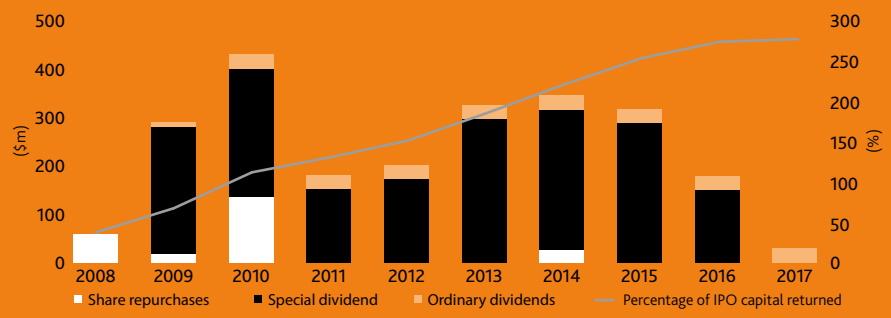
We hedge our interest rate risk with risk assets and aim to minimise the downside on our investment portfolio.

In volatile and harsh conditions, we operate nimbly to achieve the maximum return for our shareholders across the market cycle. As new opportunities emerge in the future, our focused yet diversified books will give us the ability to capitalise on opportunities and deliver our cross-cycle strategic goal of maximising risk-adjusted returns across the cycle.

We are able to react quickly to seize opportunities

Managing our capital proactively in volatile markets

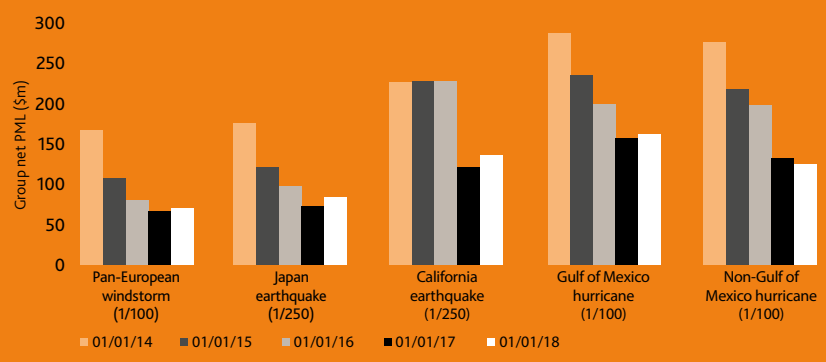
Proven record of active capital management



Description
Despite the difficult market and a significant number of catastrophe events in the year, Lancashire's capital base remains strong and positions us to remain relevant in the current market environment.

Managing the cycle by reducing net exposures

Net PMLs by key catastrophe perils



Description
We continued to modify our exposure to key catastrophe perils as the market became more competitive, demonstrating our discipline and nimbleness across the market cycle.

Responding to challenge

For Lancashire the recent catastrophe events have afforded a real world 'stress test' to our strategy and business model, and one which has validated our strategic decision to moderate our risk exposures during the softer part of the insurance cycle.

How did Lancashire respond to the sequence of natural catastrophes during 2017?
One of the central challenges for any board or management team is to understand the principal factors which can stress a business. What are they, where do the risks and opportunities lie and how best to respond?

In recent years, Lancashire had faced the challenge of a relatively benign loss environment (subject to exceptions in certain lines of business) resulting in the accumulation of capital across the global (re)insurance sector and a gradual decline in premium rates. In general terms, the (re)insurance sector has tended to be paid less for the risks underwritten. Put simply, the business has been operating in the softer part of the (re)insurance cycle. Lancashire's strategic response has been to focus on maintaining market-leading underwriting and to carefully manage risk exposures, through the disciplined underwriting of inwards insurance and reinsurance risks and through careful planning and purchasing of outwards reinsurance protections.

Insurance (and reinsurance), as a product, is designed to help insured businesses plan for and respond to damage and disruption arising from fortuitous and unpredictable events, in particular natural catastrophes. Events such as hurricanes and earthquakes are the result of natural processes which are certain to occur as part of the cycles of nature. However, in the short term, their location, frequency and severity cannot be accurately predicted, although human ingenuity has produced probability models which have enhanced our understanding of the risks and, combined with the benefits of practical underwriting experience, helped inform our commercial assumptions.

In the second half of 2017, we witnessed the occurrence of three major hurricanes: Harvey, Irma and Maria, two earthquakes in Mexico as well as wildfires in California. These catastrophes impacted upon areas of higher asset values and insurance market penetration, in particular in the U.S. and the Caribbean. For Lancashire, these recent catastrophe events have afforded a real world 'stress test' to our strategy and business model, and one which has validated our strategic decision to moderate our risk exposures during the softer part of the insurance cycle.

The Board was pleased at the way in which Lancashire proved itself capable of balancing the expectations of all its significant stakeholders in the face of the recent loss events. Most importantly, Lancashire has addressed the insurance needs of its clients within a transparent and robust risk framework. We have operated a business which has met the expectations of the Group's regulators whilst ensuring that, in a year which has seen a higher than usual sequence of natural catastrophe events, the Group's investors and capital providers have not been subject to outsize or unexpected losses. All this has been made possible through the contributions of our skilled employees. On behalf of the Board I would like to thank Alex, his management team and all our employees for a job well done.

Please see my introduction to the Governance Report on page 42 for an account of the work of the Board and our governance arrangements for the year.

Will strategy change in 2018?
I do not expect Lancashire's strategic priorities to change in 2018. We will continue to focus on underwriting expertise and discipline, to effectively balance the equation of risk and return, and to operate nimbly through the cycle. What we do cautiously hope to see in this post-loss environment is an improvement in general pricing conditions, which may lead to greater opportunity in the underwriting space and a rebalancing of the risk and return equation. Alex discusses these dynamics in greater detail in his review on page 12. From a Board perspective our job is to ensure that we afford the business the capital and human resources necessary to develop any opportunities whilst ensuring that we establish and operate within appropriate risk tolerances. Predicting the future is never straightforward, but on the assumption that pricing improves and that the catastrophe loss environment is less extreme in 2018 than it proved to be in 2017, the Board would hope to see returns improving and more aligned with our cross-cycle expectations.

Peter Clarke
Non-Executive Chairman

"Predicting the future is never straightforward, but on the assumption that pricing improves and that the catastrophe loss environment is less extreme in 2018 …, the Board would hope to see returns improving and more aligned with our cross-cycle expectations."

Dividend Yield

1.6%

Total investment return

2.5%

Has Lancashire's dividend and capital management strategy changed?
The short answer is 'no', our dividend and capital management strategy has not changed. The dividend policy is set out on page 80 of this Annual Report and Accounts.

However, due to the exceptional loss environment during 2017 and our changing view of the (re)insurance markets, the Board decided not to pay an exceptional special dividend that our investors have enjoyed in recent years. Lancashire has however declared standard ordinary dividends for the 2017 year amounting in aggregate to $0.15 per common share.

As a business we carefully consider the balance of risk and return when setting our capital levels. In previous years this approach enabled us to return capital that we did not need to support our underwriting. As we enter 2018, we believe there is a realistic prospect that the balance of risk and return will change in the current market. In the current fluid environment, the Board has decided to retain more of the Group's capital to best support our underwriting strategy and to position the business to take a lead in establishing improved pricing and terms of coverage following a period of market dislocation.

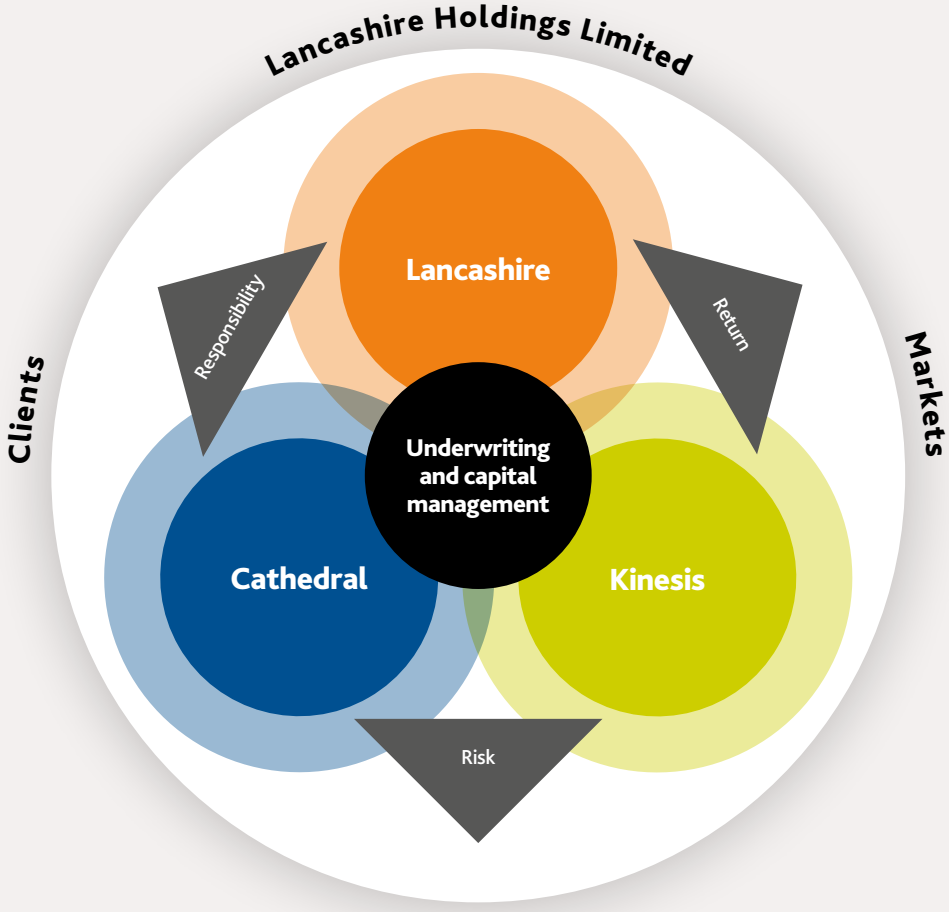
An important element to Lancashire's active capital management strategy is the flexibility afforded to us by shareholders during the last six years to issue up to 15 per cent of Lancashire's shares on a non pre-emptive basis. The best opportunities in the insurance and reinsurance sectors typically arise following major loss events, and the flexibility to issue shares and raise capital quickly is a central pillar of our business strategy and will help Lancashire maximise underwriting opportunities for the business. Once again, the Company is seeking shareholder support for resolutions at the 2018 AGM allowing this capital management flexibility, and I would encourage all shareholders to vote in favour.

Peter Clarke
Non-Executive Chairman

Three platforms weathering all storms

We leverage our deep underwriting expertise with efficient management of capital and resources across our three platforms to provide our clients and brokers with excellent solutions for their insurance and reinsurance needs. We always focus on the risk-adjusted return.

Our responsibility
We recognise that our responsibility as a company and as individuals reaches wider than our shareholders and our clients. We strive to be a good employer, a good corporate citizen and a responsible preserver of resources. Through the Lancashire Foundation, we make financial contributions and provide human support to a number of good causes in the places we operate around the world (for further details see pages 36 to 41).



	Lancashire Companies	Cathedral	Kinesis
Key strengths	• Strong brand with clients and brokers • Recognised for significant capacity and leadership ability in well-defined business sectors • Proven track record of supplying capacity across the cycle with consistently high performance • A lean business operation allows us to remain nimble and make decisions efficiently • A stable core book of business and disciplined underwriting • Strong record of capital management actions to optimise and adjust capital and navigate market cycles • Experienced management team with proven ability	• Manages two active syndicates • Strong relationships with clients and brokers • Recognised for long-term consistency of relationships • Efficient Lloyd's capital model allowing Cathedral greater premium leverage • Worldwide licensing maintained by Lloyd's allows Cathedral to write business worldwide with limited regulatory overheads • Use of world's oldest insurance third party capital, the Names, who provide support and capacity to Syndicate 2010 • Proven track record with more than four years as part of the Lancashire Group	• Experienced, fully dedicated management with strong relationships with clients, brokers and investors • Ability to leverage Group relationships and reputation with investors and clients • Highly specialised multi-class product with barriers to entry in terms of data and modeling expertise • Ability to raise and deploy capital quickly • Strong investor base since 2014 • Proven track record with Kinesis now in its fifth year
Goals	• Maintain key client, broker and reinsurer relationships to ensure the continued flow of business • Continue the use of reinsurance solutions to uphold risk-adjusted balance across the insurance market cycle • Retain 'underwriting comes first' culture and discipline without being tempted into innovation or diversification for its own sake • Provide profitable growth in areas experiencing an improved rating environment	• Maintain core portfolios in the syndicates • Continue to look for new opportunities for bolt-on business lines in both syndicates • Leverage the Group's balance sheet and cross-sell where opportunities arise	• Ensure product is correctly calibrated to meet clients' needs in terms of responding to events and providing capital relief • Deliver returns in line with expectations for modeled ranges given market losses and pricing • Continue to increase number of investors • Provide bespoke and flexible products to match investor and client appetite
Risks	• Influx of new capacity and further development of broker facilities with less robust underwriting controls • Pressure on insurance rates across the market cycle • Widening terms and conditions being accepted by the insurance market without adequate pricing or exclusions	• Pressure on signings and participation given relatively small line sizes • Expanded burden of regulatory oversight or overlapping regulation from Lloyd's, the PRA and the FCA	• Increased competition from traditional and collateralised markets, with attempts to replicate the Kinesis product • Possible waning of investor interest in insurance allocations as interest rates begin to increase and yields return to capital markets • Resistance to complex reinsurance products amongst clients, given cheap availability of traditional products

Responding to opportunity

We are strongly positioned, with the right expertise and good relationships with our clients, their brokers and our capital providers, to take the lead in establishing better-priced and more sustainable insurance and reinsurance markets and to remain a relevant and valued provider of insurance and reinsurance solutions.

Did Lancashire perform as you expected in 2017?
Our results for 2017 have generated a return on equity of negative 5.9 per cent and a combined ratio of 124.9 per cent, which may at first sight seem lacklustre compared with Lancashire's performance in previous years. Whilst no CEO likes losing money, this is to be expected in what has been a significant year for catastrophe insurance losses across the market. On balance I am satisfied with this outcome during a year in which we had worked hard to moderate our risk exposures whilst remaining relevant to the needs of our policyholders and the expectations of our investors during the soft part of the market cycle.

The recent run of catastrophe losses, which regrettably caused much human suffering and property damage, has resulted in losses to the global insurance markets which are estimated to be in excess of $100 billion, placing the 2017 year within the top three years for aggregate industry insured losses in recent history and ultimately could end up being the costliest on record. Over the last few years, I have spoken regularly about the oversupply of capital and the resulting imbalance which this has generated, leading to downwards pricing and pressure on coverage terms within the international insurance and reinsurance markets. Lancashire's response to those market conditions has been to demonstrate good inwards risk selection through underwriting discipline and to manage down its aggregate risk exposures through the judicious purchase of more and better-priced reinsurance coverage. We have bided our time for precisely the moment when there would be a marked increase in major catastrophe losses. That moment came in 2017. Faced with the 2017 loss events, our combined ratio is indicative of the success of our strategy to moderate our risk exposures in what has been a lower-yield underwriting environment.

As we enter 2018, we find ourselves well positioned, with the right people and expertise and a robust balance sheet. We have strong relationships with our clients, their brokers and our capital providers. Lancashire stands ready to take the lead in establishing better-priced and more sustainable insurance and reinsurance markets and to remain a relevant and valued provider of insurance and reinsurance solutions.

How do you view current market conditions?
After 25 years' experience as an underwriter, I firmly believe that the (re)insurance business is cyclical in its fundamentals. Due to an overabundance of capital and a protracted period of lower loss activity over a number of years, the beginning of 2017 marked a low point in the cycle of pricing and terms and conditions. Recent experience suggests to me that the market cannot continue to operate at the very margins of profitability. The 2017 catastrophe events should mark a point at which the balance of capital and underwriting opportunity will readjust, at least in the short to medium term. For the first time in several years I am cautiously optimistic that we will see a halt in the year-on-year decline in premium rates and a return to stronger underwriting discipline across the whole insurance and reinsurance sector.

"For the first time in several years I am cautiously optimistic that we will see a halt in the year-on-year decline in premium rates and a return to stronger underwriting discipline across the whole insurance and reinsurance sector."

Alex Maloney
Group Chief Executive Officer

Return on equity
-5.9%

Combined ratio
124.9%

Loss after tax
$71.1m

In which classes of business do you expect to see the greatest change?
The early evidence suggests that pricing has started to improve, in particular in the U.S. property insurance and reinsurance lines, which have been directly affected by the recent losses. But I am also hopeful that a return to the fundamentals of good underwriting will extend to those other specialty lines which we underwrite. There is, at the very least, a likelihood that the decline in pricing will come to a halt and a reasonable prospect of improved and more sustainable pricing across many of our lines of business.

Paul Gregory, our Group CUO, sets out his view of the likely trends in our core lines of business on page 20 of this Annual Report and Accounts. I believe that a move to a market which is more realistically and sustainably priced is ultimately in the best interests not only of the (re)insurance sector itself but also of our clients, who value continuity and professionalism from their insurance and reinsurance partners. Price is not the sole determinant of value for our products.

How is Lancashire different from other businesses?
We remain a business with a relatively small headcount of around 200 and we continue to pride ourselves on having a lean and nimble 'can do' business culture. During 2017, we implemented a reorganisation of our London office and, whilst that may seem a mundane step, it has helped us become even more joined-up between our businesses in London and Bermuda, our Cathedral Lloyd's platform and Kinesis, our third party reinsurance facility. We are a business with a very flat hierarchy and efficient lines of communication. We have the operating structure to respond quickly to the insurance and reinsurance needs of our clients and their brokers and to offer a level of underwriting and claims service, security and professionalism which often exceeds that of many of our larger competitors. We pride ourselves on doing what makes sense as disciplined underwriters. Rather than targeting growth or faddish diversification we have focused on management of the (re)insurance cycle, if necessary refusing business and exposures which have been underpriced. This positions Lancashire well to develop the best opportunities, which should arise when we enter what I hope may become a more rewarding phase of the market cycle.

I would like to thank all our staff across the Group for having contributed to the successful negotiation of what has been a challenging phase of the (re)insurance market cycle. I know that the skill and dedication of our people is key to the success of Lancashire and I look forward to leading our excellent team as we develop the market opportunities and face the challenges which lie ahead in the coming year.

Alex Maloney
Group Chief Executive Officer