MAINTAINING STRONG *PERFORMANCE*

ELAINE WHELAN
Group Chief Financial Officer

Both insurance and investment markets continue to be challenging, but we have remained patient and maintained our discipline. That has produced an RoE of 13.5 per cent, a combined ratio of 76.5 per cent and an investment return of 2.1 per cent: strong performance in a tough environment.

How has Lancashire maintained balance during 2016?

In the current phase of the cycle there are many factors to consider – it really is a bit of a balancing act. We want to have enough capital to be able to write the deals we think still look attractive, while managing broker and client relationships to decline those we do not. We don't want to carry too much capital, but in the current environment we are a little defensive and carry a bit more of a buffer than we typically would. There is a lot of uncertainty in the markets just now. That uncertainty also impacts our investment portfolio, but we continue to ignore the noise and invest for the longer term, protecting our capital and making tactical adjustments as necessary. On the expense side, we have always chosen to be leanly staffed so we are appropriately structured for all aspects of the cycle. With only two physical locations in Bermuda and London we are also better able to communicate and respond more quickly than some larger international companies might. It's a careful balance, but one that is paying off.

So how would you sum up 2016 performance?

2016 has been another year of attrition hurting the industry – a number of events have impacted the market, but none have been large enough either individually or collectively to drive any meaningful change in pricing, let alone a hardening of the market. We have continued to focus on both superior risk selection and our core clients' needs, while managing our exposures through reinsurance. We increased our reinsurance spend again this year, taking advantage of well-priced opportunities there. While there is undeniably a cost to that, we have reaped the benefits of increased recoveries this year, particularly on our energy book. On a risk-adjusted basis we are still able to produce an acceptable return, yet manage our downside risk. Our RoE for the year was 13.5 per cent and our combined ratio, excluding fee income, was 76.5 per cent. Including fee income our combined ratio was 72.3 per cent. Lancashire contributed 9.1 per cent to our RoE, with Cathedral and Kinesis contributing 3.6 per cent and 0.8 per cent respectively. In short, it's a strong performance in difficult markets.

Are the Group's three platforms performing in line with expectations?

The short answer is yes. The original Lancashire (London and Bermuda) platform continues to produce the majority of the Group's return. When we purchased Cathedral in November 2013, we said we expected it to contribute 2 to 3 per cent per annum to our RoE. Ignoring acquisition adjustments in the earlier years, it is actually exceeding those expectations. Kinesis is opportunity driven and could get to a size where it also

FINANCIAL HIGHLIGHTS

	2016 $m	2015 $m	2014 $m	2013 $m	2012 $m
Gross premiums written	**633.9**	641.1	907.6	679.7	724.3
Net premiums written	**458.7**	481.7	742.8	557.6	576.1
Net premiums earned	**488.1**	567.1	715.6	568.1	582.6
Net insurance losses	**142.5**	155.7	226.5	188.1	174.1
Net underwriting income	**213.5**	265.2	335.7	254.2	289.1
Net investment income	**29.8**	29.8	28.6	25.4	32.5
Net realised (losses) gains and impairments	**(2.4)**	(2.8)	(5.9)	12.6	11.8
Net operating profit	**144.0**	173.4	231.9	184.2	220.3
Profit after tax	**153.8**	181.1	229.3	222.5	234.9
Net change in unrealised gains/losses on investments	**4.1**	(11.3)	(2.1)	(32.5)	17.8
Comprehensive income	**157.9**	169.8	227.2	190.0	252.7
Dividends[1]	**178.9**	317.5	321.0	325.6	201.4
Diluted earnings per share	**$0.76**	$0.91	$1.16	$1.17	$1.29
Diluted operating earnings per share	**$0.71**	$0.87	$1.17	$0.97	$1.21
Fully converted book value per share	**$5.98**	$6.07	$6.96	$7.50	$7.83
Return on equity	**13.5%**	10.9%	13.9%	18.9%	16.7%
Return on equity excluding warrant adjustments	**13.5%**	13.5%	14.7%	18.9%	17.1%
Net loss ratio	**29.2%**	27.5%	31.7%	33.1%	29.9%
Net acquisition cost ratio	**27.1%**	25.8%	21.4%	22.1%	20.5%
Expense ratio	**20.2%**	18.8%	15.6%	15.0%	13.5%
Combined ratio	**76.5%**	72.1%	68.7%	70.2%	63.9%
Accident year loss ratio	**46.2%**	46.0%	35.9%	36.1%	34.6%
Net total return on investments[2]	**2.1%**	0.7%	1.0%	0.3%	3.1%

(1) Dividends are included in the financial statement year in which they were recorded.
(2) Net return on investments includes internal foreign exchange hedge.

contributes 2 to 3 per cent to our RoE, but that's a hard market contribution. We currently expect around 1.0 per cent, subject to loss performance and collateral releases. It is currently performing right in line with those expectations.

How have the departures of Cathedral employees impacted financial performance?

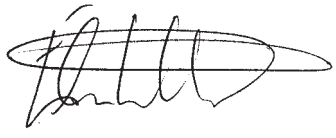
Well we haven't lost any business as a result of the departures, but did incur some costs early in 2016 – about $1.7 million. We've fully re-staffed now and expect the ongoing cost base for Cathedral to be pretty stable. There were a number of RSS awards granted to certain Cathedral employees on acquisition – a total of £18.7 million. A large portion of those have been, or will be, forfeited as individuals have left, or are leaving, prior to vesting. Of the original awards issued, only £6.4 million remain for future exercise. While the forfeits don't impact RoE there is a benefit to EPS and also simply an economic benefit from no longer having to settle those awards or the dividend equivalents on them.

How does the decline in Sterling impact the business?

As a U.S. dollar company, with about 60 to 70 per cent of our cost base in Sterling, we will see some benefit from the fall in Sterling. The extent of that obviously depends on how low Sterling falls and for how long. For the 2016 financial year, as compared to 2015, we have a saving of approximately $10.0 million in our operating expenses.

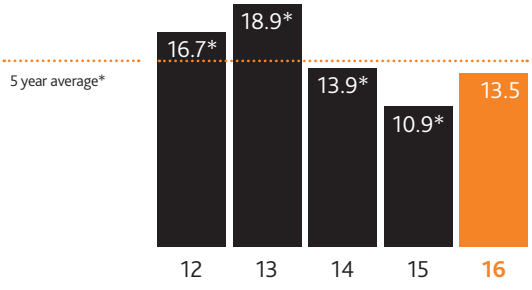
How has capital been managed in 2016?

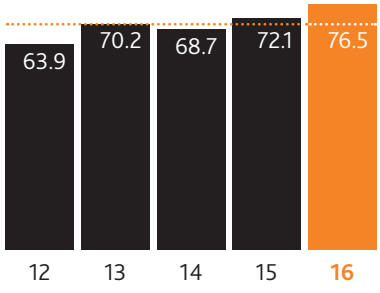
Our capital philosophy remains unchanged. We work out what business we want to write, and then we work out the capital we need to support that. We add a buffer and any excess beyond that buffer is returned to shareholders. As I mentioned, occasionally we will hold a little more of a buffer in times of market stress or where we think there may be an impact from other external factors that are out of our control. We are currently carrying a little more of a buffer than we typically would as we think 2017 is going to be an interesting year in a number of respects. Even with that buffer, we have returned a total of $178.9 million this year or 113.3 per cent of comprehensive income. That's a dividend yield of 10.5 per cent. Including the dividend declared on 15 February 2017, our capital return since inception stands at $2.7 billion or 104.2 per cent of comprehensive income.

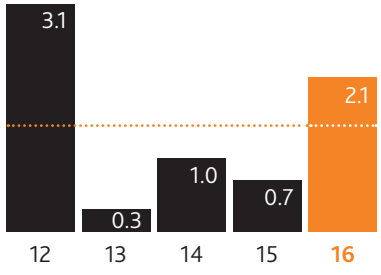


Elaine Whelan
Group Chief Financial Officer

	RETURN ON EQUITY*	COMBINED RATIO	TOTAL INVESTMENT RETURN
Aim	The Group's aim is to provide shareholders with a risk-adjusted return on equity of 13 per cent in excess of the risk-free rate over the longer term.	The Group aims to price its business to ensure that the combined ratio in any year is significantly less than 100 per cent.	The Group's primary investment objectives are to preserve capital and provide adequate liquidity to support the Group's payment of claims and other obligations. Within this framework we aim for a degree of investment portfolio growth.
Measurement	The return on equity is measured by management as the internal rate of return of the increase in fully converted book value per share in the period, adjusted for dividends.	The combined ratio is the ratio of costs to net premiums earned and is a measure of an insurance company's operating performance. It is calculated as the sum of the loss ratio, the acquisition cost ratio and the expense ratio. These ratios are defined in our glossary.	Total investment return measures investment income and net realised and unrealised gains and losses produced by the Group's managed investment portfolio.
Performance	13.5%	76.5%	2.1%



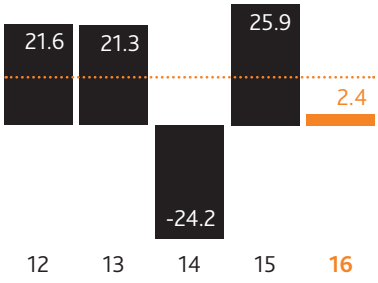


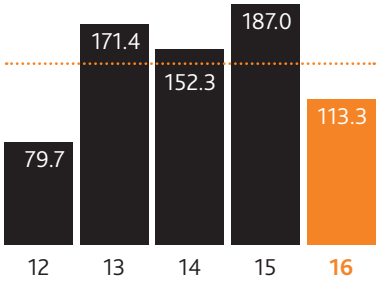


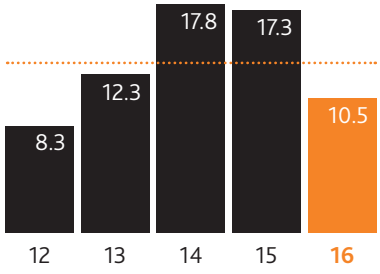
	Our market in 2016 remained in a soft phase. We recognise that whilst we have attained very high RoEs in the recent past, at this stage of the cycle we cannot expect to earn such high returns. But we continue to focus on getting the best risk-adjusted return for our shareholders. In 2016 we continued to buy more reinsurance and retrocession protection to reduce our exposures to protect our balance sheet for the eventual market turn.	Whilst the combined ratio in 2016 was above the five-year average, it was still an excellent result compared to some typical market combined ratios above the 90 per cent mark. In the context of a softening market and corresponding downward pressure on premiums, we would expect the combined ratio to increase.	In 2016, Lancashire continued to monitor risk-on/risk-off volatility and maintained the allocation to risk assets in the surplus portfolio as a hedge against the interest rate risk inherent in the significant fixed maturity allocation of the portfolio. However, given the liquidity and duration needs of the business, the composition of the core portfolio is unchanged.
Risk management	The stated aim is a long-term goal, acknowledging that management expects both higher and lower results in the shorter term. The cyclicality and volatility of the insurance market is expected to be the largest driver of this pattern. We seek to align our variable remuneration to shareholders' interests by having an RoE component in this. Please refer to the Directors' Remuneration Report on page 69 for further details.	The Group's underwriters assess likely losses, using models, their experience and knowledge of past loss experience, industry trends and current circumstances. This allows them to estimate the premiums sufficient to meet likely losses and expenses. Peer reviews of risks are conducted through the daily underwriting call or peer review, depending on risk impact, enabling the Group to ensure careful risk selection, limits on concentration and appropriate portfolio diversification. The RRC then monitors performance at a portfolio level.	The investment strategy places an emphasis on the preservation of invested assets and provision of sufficient liquidity for the prompt payment of claims, in conjunction with providing a reasonably stable income stream. These objectives are reflected in the Group's investment guidelines and its conservative asset allocation. Management reviews the composition, duration and asset allocation of the investment portfolio on a regular basis in order to respond to changes in interest rates and other market conditions.

* RoE excluding the impact of warrants was 13.5% in 2015, 14.7% in 2014, 18.9% in 2013 and 17.1% in 2012. The five-year average was 15.5%.

TOTAL SHAREHOLDER RETURN	PERCENTAGE OF COMPREHENSIVE INCOME RETURNED TO SHAREHOLDERS	DIVIDEND YIELD	
The Group's aim is to maximise RoE over the longer term and we would expect that to be reflected in our share price and multiple. This is a long-term goal, recognising that the cyclicality and volatility of both the insurance market and the financial markets in general will impact management's ability to maximise the share multiple in the immediate term.	The Group aims to carry the right level of capital to match attractive underwriting opportunities, utilising an optimal mix of capital tools. Over time, through pro-active and flexible capital management across the cycle, we aim to generate optimum returns for shareholders.	The Group aims to maintain a strong balance sheet whilst generating an attractive risk-adjusted return for shareholders. Lancashire's dividend yield demonstrates our ability to operate nimbly through the cycle through the active capital management that underpins our business model. We pay annual ordinary dividends, and when we cannot utilise our profits by retaining them as additional capital we return them to shareholders by way of special dividends.	*Aim*
Total shareholder return is measured in terms of the internal rate of return of the increase/decrease in share price in the period, measured in U.S. dollars and adjusted for dividends.	The percentage of comprehensive income returned to shareholders equals the total capital returned to shareholders through dividends and share repurchases paid in a given year, divided by the Group's comprehensive income.	Dividend yield is measured by dividing the annual dividends per share by the share price on the last day of the given year.	*Measurement*
2.4%	113.3%	10.5%	*Performance*







5 year average

Volatility in the markets, continued insurance M&A activity and the UK Brexit vote have all impacted the U.S. dollar share price in 2016.	In view of the current market outlook Lancashire took the decision to return surplus capital to shareholders due to the lack of opportunities meeting internal hurdles outside the core book.	During 2016 we paid annual ordinary dividends of $0.15 per share and a special dividend of $0.75 per share.	
The Lancashire remuneration structure and share scheme ensure that staff are highly motivated and closely aligned to the Group's goals, and therefore with shareholders. Permanent staff are all eligible to receive RSS awards. The participation of employees in the RSS ensures that there is a strong focus on sustainable long-term shareholder value.	Risk tolerances are set at a level that aims to prevent the Group incurring losses that would impair its ability to operate. The Group's key capital measure is its A.M. Best rating, and a minimum rating of A– is considered necessary to attract business. In 2016, Lancashire maintained its A rating.	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. The Group has to ensure that all shareholders understand that in hard markets the Group will want to retain, and even raise, capital to take full advantage of underwriting opportunities.	*Risk management*

KPI linked to Executive Directors' remuneration. For more information see pages 61 to 79.

BALANCING THE CYCLE *DELIVERING RETURNS*

PAUL GREGORY
Group Chief Underwriting Officer

2016 was a turbulent year. The volatility within the market and its softening conditions made for an environment that required careful navigation. The Lancashire Group has the underwriting teams, with the appropriate client and broker relationships, to balance these factors while delivering strong returns.

PROPERTY REINSURANCE

The trend of recent years continued in the reinsurance industry with an absence of significant monetary losses in the sector. Mother Nature was certainly not quiet, with earthquakes in Italy, New Zealand, Japan and Ecuador, hurricanes and storms in the U.S. and the Caribbean and wildfires in Canada. Whilst these events sadly led to loss of life, the financial impact to the industry was relatively modest, and certainly not at the levels required to change market conditions. None of the aforementioned events created industry losses in excess of $5 billion. This prolonged period of historically benign loss activity has meant that the property reinsurance market continues to be a challenging environment in which to operate. Despite a general realisation that macro-market margins are too tight to sustain any real uptick in loss frequency or severity, the levels of competitive pressure dictate that rates continue to fall, albeit the pace of change is certainly slowing. Notwithstanding these conditions, our portfolio of property reinsurance risk across the Group continues to perform well, acknowledging of course the benign loss environment. In these difficult trading conditions leveraging the strong client and broker relationships we have across the Group becomes even more important, so being better and more efficient with our Group offering will only benefit the underwriting result.

ENERGY

The 'perfect storm' of 2015 meant that the waters remained very choppy throughout 2016. The oil price stabilised somewhat and the retraction of demand was certainly less severe than the prior year. However, the demand and supply imbalance remained in 2016, hence the continuation of extremely challenging market conditions. In the space of 24 months, the premium into the upstream energy market has more than halved due to both rate reductions and demand slippage. The poor loss experience of 2015 continued through 2016 with a number of small to medium-sized losses as well as what could be the largest upstream energy loss since Deepwater Horizon in 2010. In summary, the last two years in the upstream energy market have been challenging, with premium haemorrhaging from the market and loss activity increasing in both frequency and severity. That said, the Group is fortunate to have relationships with strong and well-run companies, and as a result has been able to weather the storm. A continued focus on risk selection and being unconcerned about top line premium helps deliver underlying results that outperform the macro-market metrics. Energy has always been a core pillar of the Group's strategy and will continue to be so. We understand and accept that the energy market is a volatile place but remain committed to both the market and, more importantly, our clients and their brokers. Together we will work through these tougher times and come out the other side stronger as a result.

TERRORISM, POLITICAL VIOLENCE AND POLITICAL RISKS

The world was a volatile place during 2016 with a continuation of uncertainty and instability across the globe. Sadly, the activity of certain terrorist groups shows no signs of ceasing and the world witnessed atrocities during 2016. These included numerous well publicised attacks across Europe in France, Germany and Belgium as well as a continuation of wars in various countries including Ukraine, Syria and Yemen. In addition to this, there have been the perceived seismic political events of Brexit and the U.S. elections which create a world of increased uncertainty. This creates challenges for underwriting the terrorism and political risk classes of business. However, the events of recent years have not created any significant losses to the insurance market, and therefore capacity has continued to enter the class, creating more competition. We accept that ultimately it is demand and supply that dictate market direction and unfortunately the market will not correct itself purely based upon the logic of being in a more unstable political environment. Given this, risk selection remains paramount and, as with other classes of business, we have built up a profitable core portfolio of business which is ours to defend and which is far easier than trying to build out a new portfolio in a challenging market. We continue to choose not to support broker facilities whereby we are required to 'give our pen away', something that we will continue to resist as long as possible in order to maintain our underwriting standards and therefore control the risk we put onto our consolidated balance sheet. The Group uses its ability to offer significant capacity across multiple platforms to ensure it is providing both clients and brokers with a fully rounded product and service which allows it to maintain its underwriting principles despite the many challenges the markets contain.

PROPERTY DIRECT & FACULTATIVE

Much like the property reinsurance portfolio, the direct property market has seen a number of small events impact the profitability of the class. The Canadian wildfires and Hurricane Matthew are the most obvious examples, but nothing sufficient to create a market dislocation and positive change to the rating environment. Therefore the property insurance market remains competitive, albeit different parts of the market are experiencing different levels of competition, and this is highlighted within our portfolio. The Group's portfolio is made up of two parts, commercial open market property risks and binders. The market conditions of this sector are predominantly driven by the demand and supply dynamics within the class, more so than any other external factors that you may see in other classes. Over the past few years the appetite of the insurance market for open market business has increased dramatically and consequently that part of the market has witnessed intense competitive pressures, driving rates downwards. This part of the Group's portfolio reduced through the course of 2016, as underwriting discipline was maintained and risks that no longer met the return hurdles were declined. Where possible, facultative reinsurance is used to modify the impact of market conditions and help the Group maintain long-standing client relationships, but this is not always possible. In contrast, the binder portfolio has been far less competitive and more stable and now forms a larger part of the overall portfolio as the rate reductions are far less severe and the long-standing nature of client relationships means there is less pressure on each risk. The dual impact of a reducing open market book and a consistent binder book creates a portfolio where, for the first time in many years, the binder percentage of the portfolio will be greater than the open market risks. This is expected in the softer part of the cycle and it demonstrates the value of the consistently performing binder book as it allows the Group to maintain its underwriting discipline on the open market risks. When the market environment changes this trend will likely reverse, but in the softer market this allows the portfolio to maintain its profitability.

MARINE

The cargo market can be seen as the barometer for world trade and if there is economic uncertainty then demand will be impacted. This has certainly been the case in recent years. Market conditions, as in all other lines of business, are competitive with a surplus of capacity. However, the core portfolio of business has been defended, rate reductions have been manageable, and the portfolio profitable. Without the pressure to grow top line income, the portfolio is stable and will ebb and flow with both the demand and rating environment. The hull, builders' risk and war portfolios are historically very stable portfolios of business that have changed very little since the inception of the Group. Much like the cargo portfolio, the size of this book will rise and fall in line with market conditions and, once again, the profitable portfolio of risks has been defended. Whilst market conditions remain as they are, the underwriting appetite will not change. Making an underwriting profit in marine classes is historically the exception rather than the rule, and we intend to remain the exception.

AVIATION

The Group underwrites both aviation insurance and reinsurance, and both markets are extremely challenging. During 2014 and 2015, losses to the aviation markets increased in frequency and severity. 2016 had fewer and less severe market losses. Rates continue to be under pressure but in some areas of the class it is starting to feel like the bottom may be getting close, albeit we are not there yet. In the aviation war market for example, the broker line slips that are so prevalent to the class no longer have the same levels of capacity available to them. That means that more risks have to come to the open market underwriters who tend to resist the trend for deteriorating pricing. It is small changes like this that can start to make a difference to the market dynamics. That said, like any other market, until such time as the demand and supply dynamic changes, the market conditions will not change fundamentally. So until this happens, we continue to focus on risk selection and protecting our portfolio of risks with appropriate reinsurance. Given the team we have throughout the Group, we certainly have the expertise to maximise any opportunity that may arise in the future.

STRIKING A *BALANCE*

HAYLEY JOHNSTON
Chief Underwriting Officer, LUK

SYLVAIN PERRIER
Chief Underwriting Officer, LICL

Striking a balance during a difficult year for underwriting.

BUSINESS ENVIRONMENT AND OUTLOOK

2016 was yet another difficult year for underwriting as we are now firmly in the soft phase of the underwriting cycle. Our strategy has remained unchanged as we are working to maintain our long-term profitable underwriting relationships whilst managing our outwards exposure through the purchase of well-priced, targeted reinsurance.

Our business model was always designed with the knowledge that we have to cater for all phases of the cycle. A solid return on equity and an excellent combined ratio have been achieved during 2016 and allowed us to return profits, based on our continued commitment to focusing first on our underwriting and our capital management.

Our outlook for 2017 is a continuation of current market trends. However, we expect to be able to continue to maintain our core book and consequently operate to a similar capital level as 2016, albeit with a bit more of a buffer than we normally carry given the current environment.

RENEWAL PRICE INDEX (RPI)

Lancashire's RPI is an internal methodology that management uses to track trends in premium rates on a portfolio of insurance and reinsurance contracts. The RPI is calculated on a per contract basis and reflects Lancashire's assessment of relative changes in price, terms, conditions and limits on like-for-like renewals only, and is weighted by premium volume. The RPI does not include new business and only covers business written by LICL and LUK, to offer a consistent basis for analysis. The calculation involves a degree of judgement in relation to the comparability of contracts and the assessment noted above. To enhance the RPI tool, the management of Lancashire may revise the methodology and assumptions underlying the RPI, so the trends in premium rates reflected in the RPI may not be comparable over time. Consideration is only given to renewals of a comparable nature so the RPI does not reflect every contract in Lancashire's portfolio. The future profitability of the portfolio of contracts within the RPI is dependent upon many factors besides the trends in premium rates.

PREMIUMS

Gross premiums written decreased by 1.1 per cent in 2016 compared to 2015. The Group's five principal segments, and the key market factors impacting them, are discussed below.

PROPERTY

Property gross premiums written increased by 11.3 per cent for the year ended 31 December 2016 compared to the year ended 31 December 2015. The majority of the increase was driven by new business in the political risk and property catastrophe excess of loss classes, partly offset by reductions due to the impact of non-annual policies in the political risk

The following table summarises the RPI figures for the main business classes, excluding the Lloyd's segment, using 2006 as the base year:

RPI

Class	**2016**	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006
Aviation (AV52)	**37**	41	44	49	55	59	62	68	69	80	100
Gulf of Mexico offshore energy	**111**	118	125	136	140	140	139	137	64	80	100
Worldwide offshore energy	**70**	81	91	97	100	97	88	84	68	80	100
Marine	**72**	82	91	89	86	79	80	82	80	88	100
Property retrocession and reinsurance	**103**	117	132	152	157	131	121	127	86	97	100
Terrorism	**38**	43	48	52	55	57	60	66	71	86	100
Combined	**61**	68	76	81	84	83	81	83	76	86	100

UNDERWRITING RESULTS

	2016						2015					
	Property $m	**Energy $m**	**Marine $m**	**Aviation $m**	**Lloyd's $m**	**Total $m**	Property $m	Energy $m	Marine $m	Aviation $m	Lloyd's $m	Total $m
Gross premiums written	**219.5**	**126.0**	**37.2**	**36.2**	**215.0**	**633.9**	197.2	112.0	47.6	36.6	247.7	641.1
Net premiums earned	**148.5**	**105.5**	**35.4**	**25.5**	**173.2**	**488.1**	171.3	126.5	37.7	33.4	198.2	567.1
Net loss ratio	**9.2%**	**39.3%**	**41.8%**	**(4.7)%**	**42.6%**	**29.2%**	10.6%	37.0%	13.8%	57.8%	33.4%	27.5%
Net acquisition cost ratio	**18.9%**	**45.1%**	**27.4%**	**30.6%**	**22.5%**	**27.1%**	18.4%	37.4%	34.2%	26.3%	23.0%	25.8%
Expense ratio	**–**	**–**	**–**	**–**	**–**	**20.2%**	–	–	–	–	–	18.8%
Combined ratio	**28.1%**	**84.4%**	**69.2%**	**25.9%**	**65.1%**	**76.5%**	29.0%	74.4%	48.0%	84.1%	56.4%	72.1%

and terrorism classes. Business flow in the political risk class is generally less predictable than other classes of business due to the lead time and specific nature of each deal. Rates continued to experience pressure in the property catastrophe excess of loss class.

ENERGY

Energy gross premiums written increased by 12.5 per cent for the year ended 31 December 2016 compared to the year ended 31 December 2015. The Gulf of Mexico book was responsible for most of the increase during 2016. Some new business was added in this class, but the vast majority of the increase was driven by the timing impact of multi-year deals plus the cancellation and replacement of certain contracts. The worldwide offshore book continued to experience price and exposure reductions due to the relatively low oil price, offset somewhat by the timing of renewal of non-annual deals.

MARINE

Marine gross premiums written decreased by 21.8 per cent for the year ended 31 December 2016 compared to the year ended 31 December 2015. The majority of the decrease across the class during 2016 was driven by the timing of non-annual renewals, together with a reduction in prior underwriting year risk-attaching business due to changes in the underlying exposure.

AVIATION

Aviation gross premiums written decreased by 1.1 per cent for the year ended 31 December 2016 compared to the year ended 31 December 2015. The decrease was mainly due to the timing of satellite launches on contracts written in previous years.

LLOYD'S

In the Lloyd's segment gross premiums written decreased by 13.2 per cent for the year ended 31 December 2016 compared to the year ended 31 December 2015. The decrease was primarily due to reductions across all lines of business, with rates continuing to come under pressure due to over-capacity in the market. In addition, the energy and marine cargo lines were both impacted by the low oil price. The decline in marine cargo premiums was due to the lower value of oil in transit. In the energy line, less oil production and exploration has reduced exposure.

CEDED

Ceded premiums increased by $15.8 million, or 9.9 per cent, for the year ended 31 December 2016 compared to the year ended 31 December 2015. Favourable conditions in the reinsurance market have generally allowed both Lancashire and Cathedral to buy more reinsurance limit, by adding new layers and attaching at lower loss levels for around the same outlay. The increased spend was largely due to higher cessions to various outwards facilities and additional reinstatement premiums.

EARNED

Net premiums earned as a proportion of net premiums written were 106.4 per cent for the year ended 31 December 2016, compared to 117.7 per cent for the year ended 31 December 2015. The reduced earnings percentage was due to an increase in longer tenor business written plus increased reinsurance spend.

LOSSES

The Group's net loss ratio was 29.2 per cent for the year ended 31 December 2016 compared to 27.5 per cent for the year ended 31 December 2015. The 2016 accident year loss ratio, including the impact of foreign exchange revaluations, was 46.2 per cent compared to 46.0 per cent for the year ended 31 December 2015. While there were no major losses in either 2016 or 2015, both years experienced a few mid-sized losses, primarily across the property and energy classes. Attritional losses for both years were otherwise low.

Prior year favourable development was $85.8 million for the year ended 31 December 2016 compared to favourable development of $107.7 million for the year ended 31 December 2015. Despite some adverse development on prior accident year marine and energy claims in 2016, the overall favourable development was primarily due to general IBNR releases across most lines of business due to a lack of reported claims. Experience in 2015 was similar in terms of releases, plus there was a further benefit of additional recoveries on the 2011 Thai flood losses.

The table below provides further detail of the prior years' loss development by class, excluding the impact of foreign exchange revaluations:

Excluding the impact of foreign exchange revaluations, previous accident years' ultimate losses developed as follows during 2016 and 2015:

ULTIMATE LOSS DEVELOPMENT BY ACCIDENT YEAR

	2016 $m	2015 $m
2006 and prior accident years	**0.3**	1.6
2007 accident year	**(0.7)**	1.1
2008 accident year	**1.6**	(2.1)
2009 accident year	**(18.0)**	4.1
2010 accident year	**3.2**	(3.5)
2011 accident year	**9.9**	17.1
2012 accident year	**13.5**	10.8
2013 accident year	**(1.6)**	35.4
2014 accident year	**19.9**	43.2
2015 accident year	**57.7**	–
Total	**85.8**	107.7

Note: Positive numbers denote favourable development.

The ratio of IBNR to total net loss reserves was 34.6 per cent as at 31 December 2016 compared to 35.2 per cent as at 31 December 2015.

LOSS DEVELOPMENT BY CLASS

	2016 $m	2015 $m	2014 $m	2013 $m	2012 $m
Property	**36.6**	26.4	19.8	13.2	(36.0)
Energy	**17.3**	35.2	5.4	18.4	37.4
Marine	**1.9**	13.8	(9.7)	(23.4)	25.9
Aviation	**3.9**	2.9	0.9	(1.4)	0.1
Lloyd's	**26.1**	29.4	18.0	9.1	n/a
Total	**85.8**	107.7	34.4	15.9	27.4

Note: Positive numbers denote favourable development.

ACCIDENT YEAR LOSS RATIOS

	2016 %	2015 %	2014 %	2013 %	2012 %
Accident year loss ratio	**46.2**	35.7	27.0	28.5	27.9
Initial accident year loss ratio	**n/a**	46.0	35.9	36.1	34.6
Reduction in loss ratio post-accident year	**n/a**	10.3	8.9	7.6	6.7

Note: Adjusted for revaluation of foreign currencies at the exchange rate as at 31 December 2016.

ACQUISITION COSTS

The acquisition cost ratio was 27.1 per cent for the year ended 31 December 2016 compared to 25.8 per cent for the year ended 31 December 2015. The increase was largely due to the additional reinsurance cover purchased in 2016 compared to 2015, in addition to higher profit commissions on some of our worldwide offshore business.

INVESTMENTS, LIQUIDITY AND CASH FLOW

Since inception, the primary objectives for our investment portfolio have been capital preservation and liquidity. Those objectives remain unchanged, and are more important than ever in today's volatile and reactive markets. As market volatility continues, we position our portfolio to limit downside risk in the event of market shocks. In 2016, our focus was on managing our interest rate risk, the largest risk to our predominantly fixed maturity portfolio. We continue to maintain a short duration, mostly fixed maturity portfolio and have been using our risk budget to add products to our portfolio to help mitigate a rise in interest rates. We produced a total investment return of 2.1 per cent compared to 0.7 per cent for the year ended 31 December 2015. Our average annual total investment return since inception is 2.9 per cent, and we have made a positive investment return in every year since inception, including 2008. Our portfolio mix illustrates our conservative philosophy, as shown in the table below. With the composition regulated by the Group's investment guidelines, we have three investment portfolio categories: 'core', 'core plus' and 'surplus'. The core portfolio contains at least enough funds required to meet near-term obligations and cash flow needs following an extreme event. Assets in excess of those required to be held in the core portfolio may be held in any of the three portfolio categories, which are discussed further on page 112. As at 31 December 2016 and 2015 the managed portfolio was as follows:

	2016 %	2015 %
Fixed maturity securities	**81.4**	81.6
Cash and cash equivalents	**10.4**	9.6
Hedge funds	**7.0**	8.0
Equity securities	**1.2**	0.8
Total	**100.0**	100.0

MANAGED INVESTMENT PORTFOLIO ALLOCATIONS

	2016 %	2015 %	2014 %	2013 %	2012 %
Cash	**10.4**	9.6	10.6	14.7	11.1
Short-term investments	**0.3**	1.1	1.4	9.8	5.4
Fixed maturity funds	**0.8**	0.6	0.7	1.1	–
Government debt	**20.3**	23.6	21.4	14.6	18.8
Agency debt	**4.4**	0.2	0.8	4.1	6.2
Agency MBS, CMBS	**6.4**	7.3	7.7	10.9	19.2
Non-agency RMBS, ABS, CMBS	**7.3**	8.4	11.0	8.4	5.3
Corporate bonds	**32.5**	33.2	31.7	29.7	32.2
Bank loans	**6.6**	5.9	5.8	4.5	1.8
Fixed maturity – at FVTPL	**2.8**	1.3	1.4	1.3	–
Equity securities	**1.2**	0.8	0.7	0.7	–
Hedge funds – at FVTPL	**7.0**	8.0	6.8	–	–
Other investments	**–**	–	–	0.2	–
Total	**100.0**	100.0	100.0	100.0	100.0

The composition, duration and asset allocation of the investment portfolio are reviewed on a regular basis in order to respond to changes in interest rates and other market conditions. If certain asset classes are anticipated to produce a higher return within management's risk tolerance an adjustment in asset allocation may be made. Conversely, if the risk profile is expected to move outside tolerance levels, adjustments may be made to reduce the risk in the portfolio. We try to be nimble in our investment strategy while putting our objective of capital preservation first and foremost. We believe in the application of common sense, and do not place much reliance on 'black box' approaches to investment selection.

Investments are, however, inherently unpredictable and there are risks associated with any investment strategy decisions. Recent market history has been tumultuous and we remain ever watchful. We will continue to monitor the political environment closely.

INVESTMENT PERFORMANCE

Net investment income, excluding realised and unrealised gains and losses, was $29.8 million for the year ended 31 December 2016, consistent with 2015. Total investment return, including net investment income, net realised gains and losses, impairments and net change in unrealised gains and losses, was $38.4 million for the year ended 31 December 2016 compared to $14.4 million for 2015. For the year ended 31 December 2016, the investment portfolio returned 2.1 per cent. The fixed maturity portfolios performed reasonably well in 2016 primarily due to the narrowing of credit spreads which more than offset the slight increase in treasury yields during the year. Investment income was supported by strong returns from the Group's bank loans, equities and equity linked notes during 2016. For the year ended 31 December 2015, the investment portfolio returned 0.7 per cent, reflecting the increase in treasury yields and the widening of credit spreads.

LIQUIDITY

The Group is a short-tail insurance and reinsurance group. As such, the investment portfolio must be liquid, short duration, and highly credit-worthy. As noted earlier, the Group's investment strategy places an emphasis on the preservation of invested assets and provision of sufficient liquidity for the prompt payment of claims in conjunction with providing a reasonably stable income stream.

Liquid securities will be maintained at an adequate level to more than meet expenses, including unanticipated claims payments. Only once safety, liquidity and investment income requirements are satisfied may additional growth in the investment portfolio be pursued.

CASH FLOW

The Group's cash inflows are primarily derived from net premiums received, from losses recovered from reinsurers, from net investment income, including dividends, profit commissions, fee income and other returns from its associate, and any capital raising activities performed in a given year including the issuance of debt. Excess funds are invested in the investment portfolio, which primarily consists of high-quality, highly liquid fixed maturity securities of short duration. Other cash inflows result from the sale and redemption of investments.

The principal outflows for the Group are the settlement of claims, the payment of premiums for reinsurance cover, payment of general and administrative expenses, the servicing of debt, the purchase of investment products, the distribution of dividends and the repurchasing of shares.

In 2016, whilst lower than the prior year, our operating cash flow remained strong, driven by the Group's robust underwriting performance. A net positive cash inflow arose from operations during the year of $48.9 million (2015 – $98.1 million).

KEY INVESTMENT PORTFOLIO STATISTICS

	2016	2015	2014	2013	2012
Duration	**1.8 years**	1.5 years	1.5 years	1.0 year	1.8 years
Credit quality	**A+**	AA–	AA–	AA–	AA–
Market yield	**1.9%**	1.9%	1.5%	1.2%	1.1%
Book yield	**1.8%**	1.6%	1.5%	1.4%	1.8%

LANCASHIRE THIRD-PARTY CAPITAL MANAGEMENT

The total contribution from third-party capital activities consists of the following items:

	2016 $m	2015 $m
Kinesis underwriting fees	**4.4**	5.6
Kinesis profit commission	**6.2**	7.3
Lloyd's fees & profit commission	**9.9**	7.0
Total other income	**20.5**	19.9
Share of profit of associate	**5.1**	4.1
Total third-party capital managed income	**25.6**	24.0

The reduction in Kinesis underwriting fees year on year is due to slightly less limit placed. The slightly lower Kinesis profit commission during the year ended 31 December 2016 compared to 2015 was due to the retention of a portion of the collateral held on the January 2015 underwriting cycle which is awaiting the confirmation of claims quantum. We anticipate receiving the remaining commission during the first quarter of 2017. The share of profit of associate reflects Lancashire's 10 per cent equity interest in the Kinesis vehicle.

The higher Lloyd's fees and profit commission during the year ended 31 December 2016 compared to 2015, was driven by the timing of profit commission on the 2014 year of account, together with profit commission on consortium business.

OTHER OPERATING EXPENSES

	2016 $m	2015 $m
Employee remuneration costs	**61.4**	64.3
Other operating expenses	**37.1**	42.3
Total	**98.5**	106.6

Employee remuneration costs for the year ended 31 December 2016 were $2.9 million lower compared to 2015. A higher compensation expense due to Cathedral staff departures was recorded in 2015. Otherwise 2016 benefited from the depreciation of Sterling in the second half of 2016.

Other operating expenses were $5.2 million lower for the year ended 31 December 2016 compared to the same period in 2015, primarily due to the depreciation in Sterling.

Equity based compensation expenses were $10.7 million for the year ended 31 December 2016 compared to $15.8 million for the year ended 31 December 2015. The decrease was primarily due to the lapsing of restricted share scheme awards of former employees of Cathedral on their departure from the Group.

CAPITAL MANAGEMENT

Lancashire has built a reputation for being one of the best known and most active proponents of capital management in the industry. Capital management is our most important area of focus after underwriting and it is our firm belief that pro-active and flexible capital management is crucial in helping to generate a superior risk-adjusted return over time. With our focus on maximising shareholder return we will return capital where this offers the best returns for our shareholders. We have returned 104.2 per cent of comprehensive income generated via dividends or share repurchases since inception.

The Group actively reviews the level and composition of capital on an ongoing basis. Internal methods have been developed to review the profitability of classes of business and their estimated capital requirements and the capital requirements of the combination of a wide range of other risk categories. The key aim of the capital management process is to maintain a strong balance sheet, whilst:

- maintaining sufficient capital for underwriting opportunities and to meet obligations to policyholders;
- maximising the risk-adjusted return to shareholders within predetermined risk tolerances;
- maintaining adequate financial strength ratings; and
- meeting internal, regulatory and rating agency requirements.

The subsidiary operating entities also conduct capital requirement assessments under internal measures and in compliance with local regulatory requirements.

Capital raising can include debt or equity, and returns of capital may be made through dividends, share repurchases, a redemption of debt or any combination thereof. All capital actions require approval by the Board of Directors. The retention of earnings generated also leads to an increase in capital.

The composition of capital is driven by management's appetite for leverage, amongst other factors, including the cost and availability of different types of capital.

Maintaining a strong balance sheet will be the overriding factor in all capital management decisions. The Solvency II regulatory regime for (re)insurance in the EEA introduced a new basis for assessing regulatory capital requirements and became effective from 1 January 2016. The Group is more than adequately capitalised for supervisory and regulatory purposes under the Solvency II regime.

CAPITAL

As at 31 December 2016, total capital available to the Group was $1.528 billion, comprising shareholders' equity of $1.207 billion and $320.9 million of long-term debt. Tangible capital was $1.374 billion. Leverage was 21.0 per cent on total capital and 23.3 per cent on total tangible capital. Total capital and total tangible capital as at 31 December 2015 were $1.542 billion and $1.388 billion respectively.

DIVIDENDS

During 2016, the Lancashire Board declared a final dividend of $0.10 per common share in respect of the 2015 financial year, an interim dividend of $0.05 and a special dividend of $0.75 per common share in respect of 2016. With the final dividend in respect of 2016 of $0.10 per common share, total capital returns since inception amount to $2.7 billion, or 274.7 per cent of initial capital raised. The final dividend of $0.10 per common share has been declared and will be paid on 22 March 2017 to the shareholders of record on 24 February 2017.

NON PRE-EMPTIVE ISSUE OF SHARES

As part of the Group's flexible approach to capital management the Board has in recent years requested and received from shareholders authority to issue up to 15 per cent of its shares on a non pre-emptive basis. Lancashire believes that this ability to raise capital quickly is important in securing first mover advantage in the catastrophe insurance and reinsurance business in which it underwrites. The Board proposes to put similar requests for authority to shareholders in resolutions at the 2017 AGM to be held on 3 May 2017.

LETTERS OF CREDIT

Lancashire has a standard syndicated LOC facility which in total amounts to $300.0 million, with a $75.0 million loan sub-limit available for general corporate purposes. During 2016, Syndicate 2010 and Syndicate 3010 each had a catastrophe facility in place to assist in paying claims and gross funding of catastrophes. These facilities amounted to a combined $100.0 million with a total of $50.0 million available by way of LOCs and $50.0 million by way of RCFs. For 2017, this facility is in place for Syndicate 2010 only, providing in aggregate up to $80.0 million with a total of $40.0 million available by way of LOCs and $40.0 million by way of RCFs.

There was no outstanding debt under the above facilities at any reporting date. There are no off-balance sheet forms of capital.

BALANCING *THE ELEMENTS OF ERM*

LOUISE WELLS
Group Chief Risk Officer

Balancing all the elements of ERM is essential if we are to emerge from this soft market ready to maximise any opportunities.

THE ONGOING BALANCING ACT

With the continued soft market in 2016 it has been even more important to ensure that we are balancing the risk we take on with the reward we receive for that risk. Our focus, therefore, has been on ensuring risk management remains inherent within our everyday processes and procedures; and that those processes and procedures continue to operate effectively and efficiently.

THIS YEAR'S ERM JOURNEY

Early in 2016 we completed the implementation of our new risk system, the 'Governance Portal', which has enhanced our quarterly risk and controls' affirmation process. In addition, Internal Audit now use the system to record all audit findings and link them to the relevant risk and control. The control affirmations have not identified any significant failings or weaknesses in our key controls or associated processes.

As at 31 December 2016, all Group entities were operating within their board-approved risk tolerances. No new risks have been identified and there have not been any material changes in our existing risks. Our risk preferences reduced during 2016 as a result of the market conditions, as we work to maintain our risk and return balance.

Our quarterly own risk solvency assessment reports prepared by the CRO to the main Board, known as ORSA reports, provide a timely analysis of current and potential risks, compared to risk tolerances, along with their associated capital requirements. The third annual ORSA report was reviewed, challenged and approved by the Board during the fourth quarter of 2016 and submitted to the PRA in line with supervisory requirements.

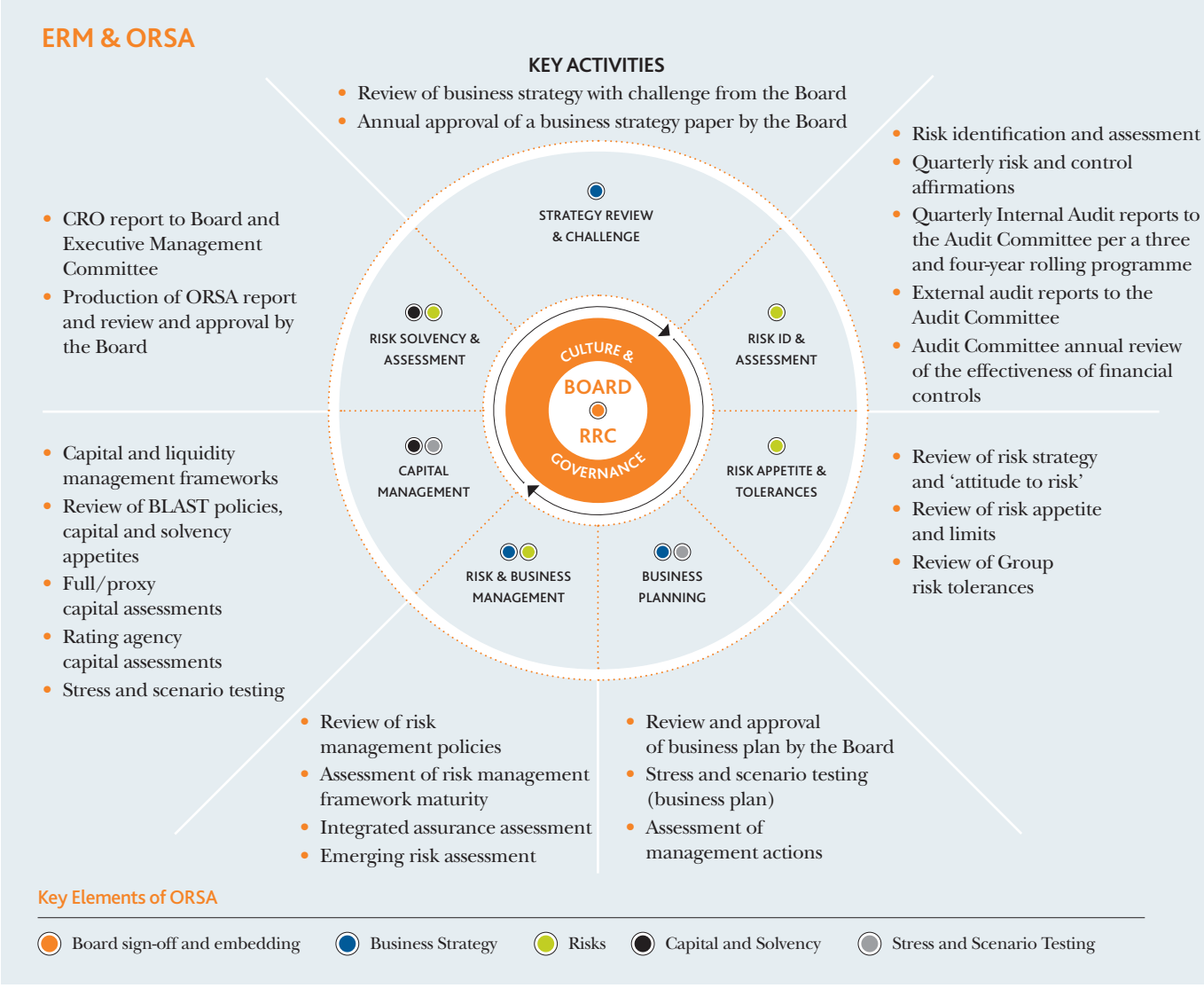
As a Lloyd's Managing Agent Cathedral falls within the Society of Lloyd's for Solvency II reporting, preparing ORSA reports for each syndicate. Cathedral has its own ERM framework to ensure adherence to Lloyd's minimum standards.

For the first time this year, the CRO reported to the Remuneration Committee regarding risk and remuneration, recognising the importance of the design of the remuneration structure in driving desired behaviours over both the short-term and the longer-term business planning periods.

LOOKING FORWARD AND MAINTAINING THE BALANCE

A detailed review of the ERM framework across the Group is planned for early 2017. This review will take into account how the existing framework has served us, current market best practice, and how the Group plans to operate going forward, with the aim of ensuring that the risk management framework meets the challenge of balancing the Group's risks and returns during the soft market and beyond.

The diagram below illustrates how we balance our ERM and ORSA activities. Our risk culture is driven from the top down via the Board and executive management to the business, with the RRC central to these processes.



RRC

The RRC, under the chairmanship of the Group CEO, is the key management tool for monitoring and challenging the assessment of risk on a continual basis. The RRC agenda is reviewed each year to ensure its activities remain appropriate and are aligned with the business cycle. The RRC reports its principal findings to the Board through the CRO's quarterly ORSA reports.

BLAST

We continue to challenge the assumptions used in BLAST and make changes where appropriate.

EMERGING RISK

As ever in 2016, the Group strove to foresee potential areas of new risk, or developments in existing risks that could threaten the Group. The political and economic outlook remains uncertain following the results of both the UK's referendum on leaving the European Union and the U.S. Presidential Election. Whilst we don't expect either to have a material impact on the Group, we continue to monitor the position. Cyber risk remains a hot topic and under scrutiny, both in our operating exposure and via our inwards insurance risk. Terrorism is an area of core business focus for the Group, and is well understood, but the continued increase in the diversity of targets and modes of attack from terrorist groups means we maintain a watch on developing trends.

RISK UNIVERSE

We continue to classify risks in three broad classes:

- Intrinsic Risk: 'Risk that stems from the inherent randomness and uncertainty that exists in the universe in which we operate and that is therefore fundamental to how we manage our business.' This is the risk we accept as inherent in the core functions of our business; so we recognise that by insuring fortuitous events we can suffer losses, and that within our investment portfolio we can see the value of investments fall. We cannot avoid these risks so we focus on the correlated operational risks and seek to mitigate them. So, for example, we know that by insuring the risk of earthquake we are exposed to the risk that losses exceed our plan. We model our portfolio using stochastic modeling to review actual and planned exposures to ensure they remain within tolerances. The correlated risks are that we might fail to design or maintain effective tolerances and limits, and fail to maintain exposures within such limits; or that we fail to keep accurate and timely records of our exposures. We then devise systems and processes to mitigate these risks, such as PML reconciliations, and RDS sign-offs, with review by the RRC and regular ORSA reports to the Board.
- Operational Risk: 'The potential for specific losses arising as a result of inadequate or failed internal processes, personnel, systems or (non-insurance) external events.' Risks that are operational in causation can be split into two sub-categories in terms of how they crystallise:
  - Independent: risks that have the potential to crystallise independently from intrinsic risk. For example, losses arising through the imposition of fines as a result of a regulatory breach, so unrelated to our core functions.
  - Correlated: risks that relate to the failure to effectively operate the processes designed to manage intrinsic risk, and which therefore have the potential to amplify its impact beyond that modeled. For example, increased reinsurer default losses arising through the use of non-approved counterparties.
- Other Risk: This is the non-financial category of risks such as reputational risk or communication risk which cannot necessarily be mitigated by holding capital since such risks may not have direct balance sheet implications. These are included within the risk register and are assessed and mitigated through scenario and stress testing.

RISK UNIVERSE

Type	Category	Description
Intrinsic Core	Underwriting Investment	Intrinsic risks representing the potential to generate a return as well as a loss. In these areas, the Group promotes informed risk taking that considers the risk and return equation in all major decisions, with the intention of maximising risk-adjusted return on equity.
Intrinsic Non-core	Reserving (Re)Insurance counterparty Liquidity	Intrinsic risks to which we are inevitably exposed as a result of conducting our day-to-day business operations yet offer no direct potential for return. They are quantified insofar as practicable for the purposes of capital and risk management and avoided or minimised insofar as is economically justifiable.
Operational	Operational	These are risks arising as a result of inadequate or failed internal processes, personnel, systems or (non-insurance) external events. They have the potential either to magnify the adverse impacts of intrinsic risks or to crystallise separately in their own right.
Other	Strategic Group Emerging	These are risks for which quantitative assessment is difficult but for which a structured approach is still required to ensure that their potential impact is considered and mitigated insofar as is practicable.

BALANCING OUR *RISKS AND OPPORTUNITIES*

As described under our review of the Risk Universe, our classification of risks as Intrinsic Core and Intrinsic Non-Core, Operational and Other helps us to focus on our management and mitigation of those risks. Further details concerning these risks can be found on pages 101 to 128. Within BLAST, insurance risk accounts for over 80 per cent of the allocated risk capital, so this is clearly the principal area where we stringently apply controls and reviews. For example, we place a large number of controls around monitoring risk levels across the business. However, we understand that even risks that do not generate a capital charge under an economic capital model can pose serious threats to the execution of the business plan and strategy, and therefore need to be monitored and tested. For example, we spend a lot of time looking at the implications of emerging capital and the evolution of the market cycle.

INTRINSIC RISK: CORE

TYPE	MITIGATION
Underwriting: Losses in our classes are hard to predict in particular as to the specifics of timing and quantum of catastrophe loss events. Additionally, we write lines of business that are subject to accumulations, including accumulations of individual risk losses arising from a single event such as several property catastrophe excess of loss programmes being affected by a windstorm or earthquake, and accumulations between business lines such as a 9/11 type event impacting both the terrorism and AV52 portfolios. Losses can also exceed expectations in terms of both frequency and severity. So, although we model losses, for example using the RMS and AIR stochastic models, we know that these projections can and will be wrong in many instances.	Modeling: We apply loads to, and stress test, stochastic models and develop alternative views of losses using exposure damage ratios. RRC: The RRC considers accumulations, clashes and parameterisation of losses and models. Capital: We set our internal capital requirements at a level that allows for buffers above accumulations of extreme events and the Board considers capital requirements on at least a quarterly basis.
Investment: We need to hold sufficient assets in readiness to pay claims, but the markets and products in which we invest can suffer volatility and losses. As a short-tail insurer, we are able to hold the majority of assets in low duration securities such as fixed income bonds. However, this creates an additional source of risk in the current environment, where there is a considerable risk from changes to interest rates as quantitative easing programmes may begin to taper or be increased. We model our investment portfolios and use various stress scenarios to see what kinds of losses we could expect under a range of outcomes.	Investment strategy: Our strategy is that investment income is not expected to be a significant driver of our returns. Our primary focus remains on underwriting as the engine of profits. Investment strategy is approved annually and monitored on a quarterly basis by the Investment Committee and Board. IRRC: The IRRC forms an integral part of our risk management framework, meeting at least quarterly and reporting to the RRC. External advisers: Lancashire's Board and management recognise that the Group's principal expertise lies in underwriting so we use the services of internationally recognised investment managers who are experts in their fields.

INTRINSIC RISK: NON-CORE

TYPE	MITIGATION
Reserving: Because we do not know the amount of losses we are going to incur at the outset of a contract, we have to make estimates of the reserves we need to hold to pay claims. If these reserves are inadequate and claims exceed them, this may have an impact on earnings, or indeed capital. Independent external reviews of our reserves look at the overall levels of expected losses, as well as individual large events, including benchmarking analyses to provide assurance over the level of reserves booked.	Short-tail business: Lancashire's focus is on short-tail lines of business where losses are usually known within, or shortly after, the policy period with a reasonable degree of certainty. Experience data: We have access to a lot of data, both our own and from the industry as a whole, about losses and loss trends. Actuarial and statistical data are used to set estimates of future losses, and these are reviewed by underwriters, claims staff and actuaries to ensure that they reflect the actual experience of the business. External review: Insurers typically facilitate an independent, external review of their loss reserves. Lancashire retains the services of one of the leading industry experts, and our appetite is defined so as to set reserves within a range of reasonable estimates based on both internal and external review. The Audit Committee of the Board reviews reserve adequacy at its quarterly meetings.

INTRINSIC RISK: NON-CORE CONTINUED	
TYPE	**MITIGATION**
Reinsurance and intermediary counterparty: Almost all the insurance policies which we write are brought to us by brokers, who act as intermediaries between us and the client and handle the transaction of payments of claims and premiums on our behalf. This exposes us to the risk of mishandling by, or failure of, the broker concerned. In order to make our portfolio as efficient as possible, we buy reinsurance to protect against severity, frequency and accumulation of losses. Again, this exposes us to the risk that our counterparties may have the inability or unwillingness to pay us in the event of a loss.	Counterparty credit limits: We use counterparty credit limits, seek to deal with reputable reinsurers, with minimum rating standards, and use collateral agreements where appropriate. The operating entities of the Group that contract for reinsurance separately maintain and report their own counterparty credit limits at the entity level. The RSC is responsible for approving counterparties and monitoring aggregate limits. The Broker Vetting Committee is responsible for the broker vetting approval process and monitoring credit risk in relation to brokers. In addition, the Lancashire companies conduct broker business using non risk transfer TOBAs. This mitigates the risk due to non-payment by brokers and intermediaries as monies are held in separated client accounts.
Liquidity: In order to satisfy claims payments we need to ensure that sufficient assets are held in a readily realisable form. This includes holding cash accounts for the expected level of attritional losses, as well as ensuring that we can meet claims payment requirements in extreme events.	Portfolio management: The Group maintains liquidity in excess of the Board agreed tolerances. This is achieved through the maintenance of a highly liquid portfolio with short duration and high creditworthiness. We monitor this through the use of stress tests and mitigate risks through the quality of the investments themselves.

OPERATIONAL	
TYPE	**MITIGATION**
These are risks arising as a result of inadequate or failed internal processes, personnel, systems or (non-insurance) external events. They have the potential either to magnify the adverse impacts of intrinsic risks or crystallise separately in their own right. This can encompass IT availability, where the failure of an IT system, such as our underwriting system, could impact our ability to maintain accurate and up-to-date records of our exposure. If correlated with an insurance loss this could cause us to breach insurance risk tolerances. It could also encompass IT integrity, where an unauthorised intruder could alter data in our systems, or introduce a bug that would corrupt the system.	Capacity: We mitigate IT availability risk by adding redundancy to the capacity we need and using backups of data including off-site storage that we test regularly. Testing and access: We mitigate the integrity risk by using independent external penetration tests, and by restricting access to key systems to only those people who are qualified and need to use them. Personnel: We mitigate the risks associated with staff retention and key-man risk through a combination of resource planning processes and controls. Examples include targeted retention packages, documented position descriptions and employment contracts, resource monitoring and the provision of appropriate compensation and training schemes. The Board regularly reviews succession planning arrangements and remuneration structures.

OTHER	
TYPE	**MITIGATION**
These are risks for which quantitative assessment is difficult but for which a structured approach is still required to ensure that their potential impact is considered and mitigated insofar as practicable. They include categories such as Strategic, Group and Emerging Risks.	Qualitative approach: These risks require a qualitative approach, engaging staff in appropriate discussions about sources of risk, and then thinking about possible outcomes. The Group Executive Committee and the RRC consider these issues, and the ORSA reports made by the CRO to the Board include standing items on Emerging Risk.

SUPPORTING COMMUNITIES – *OUR RESPONSIBILITY TO OTHERS*

WHY CORPORATE RESPONSIBILITY IS IMPORTANT TO LANCASHIRE

Corporate responsibility is an integral part of Lancashire's approach to its business. We recognise the need to balance our commitment to our shareholders, employees and more immediate stakeholders with a responsibility to support the wider communities whether within our neighbouring areas or further afield. The Lancashire Foundation, our charitable grant making body, is the cornerstone of our support. The channelling of the talents and energy of our staff in helping others in this way helps benefit and build Lancashire's business and a positive culture.

OUR APPROACH

Lancashire tries to improve society and our environment using such tools as donations by the Foundation and the allocation of staff charity days to work on local improvement projects. We limit the negative impact of our carbon footprint through mitigation strategies and offsets. As well as the direct benefits, we believe that Lancashire reaps indirect benefits in terms of its attraction as an ethical and compassionate employer, and the positive and long lasting team-building benefits of the activities undertaken. In terms of governance, the Board sets the policy for corporate donations to the Foundation and reviews reports on its activities. The day-to-day activities of the Foundation are delegated to a Donations Committee comprised of staff members from across our operating platforms, which monitors and reports on the activities of the charities to which donations are made and brings a mixture of passion and pragmatism to our charitable giving. The Board also sets the policy for the operation of the HR function, and the environmental impact of the business.

Lancashire has a relatively low headcount (fewer than 200 employees globally), all of whom are remunerated on a basis which comfortably exceeds UK minimum wage requirements. In the ancillary services and limited supply chains used by the Group, Lancashire seeks to receive assurance that its service providers pay a living wage. Concerns over human rights issues with insureds and potential clients are addressed as part of the underwriting process. During 2016, the Board approved a statement addressing modern slavery and human trafficking concerns, which is published on the Lancashire website. The Board has recently reviewed the statement on slavery and human trafficking and concluded that it remains fit for purpose.

WE FOCUS ON THE FOLLOWING FOUR AREAS:

COMMUNITY

$17.4m

donated by the Lancashire Foundation since inception

See page 37

ENVIRONMENT

100%

of our 2016 CO_2 emissions offset

See page 39

MARKETPLACE

100%

of our employees are eligible for RSS awards

See page 40

WORKPLACE

10

different countries represented by our workforce

See page 41

COMMUNITY

We remain strongly committed to engaging with our local communities in Bermuda and the UK, including those that are near to our London office, and we continue to support local initiatives and activities, through partnerships with schools, local government and local businesses.

OUR APPROACH

We support our communities through the Foundation by making donations to locally based charities and through our staff charity day release programmes and charity leave. We believe that our mixture of financial support and voluntary engagement provides greater satisfaction for our staff and greater value to our charities. In 2016, 79 of our staff members across the Group participated in one or more of the volunteering opportunities offered by Lancashire. In Bermuda we continue to sponsor a morning fresh fruit programme for primary school children, and have from time to time held staff raffles, bake sales and other fundraising efforts.

OUR FOCUS AREAS

We focus on victims of disasters and those who are disadvantaged and excluded whether through lack of opportunity, lack of resources, or just in need of a helping hand. As our business is in part based on insuring against natural disasters we know very well how disruptive they can be, so the largest Foundation donation is to MSF, who provide immediate aid in crisis situations (both natural and man-made) right across the globe. The Foundation has made significant financial commitments to charities that support families in crisis (Family Centre) and children with autism (Tomorrow's Voices) in Bermuda, and charities supporting ex-offenders throughout the UK (St Giles Trust), and a poverty relief programme in the Philippines (ICM). But we also support them in other ways, for instance renovating premises for Tomorrow's Voices, mentoring staff members for St Giles Trust and sending volunteers on week-long service missions to support some of the poorest communities in the Philippines with ICM.

We also make donations to charities suggested by staff and indeed by clients and brokers. In 2016, we supported Back Up Trust, Batten Disease Family Association, Skiing with Heroes, National Brain Appeal, Prostate Cancer Research Centre, Action Medical Research, Udaan India Foundation and SCARS, all at the suggestion of our business partners, helping to build the sense of an insurance community in Bermuda and London.

EMPLOYEE ENGAGEMENT

We recognise that the energy and talents of the people of Lancashire can make a difference in a number of ways, and that our charitable partnerships offer a valuable way to channel these generous instincts. We provide day release programmes for staff to give back to the communities in which they live and around the world. In addition, staff are entitled to up to a week's annual charity leave on completion of three years' permanent employment with the Group, which they can spend with a charity of their choice or with an existing Foundation-supported entity. The Lancashire Foundation also operates a charity matching scheme to support individual staff members' charitable initiatives. During 2016 such matched funds from the Foundation amounted to $27,373 and supported 13 charities.

CORPORATE RESPONSIBILITY IN ACTION

School Home Support

School Home Support (SHS) is an education charity. It works to ensure children are in school and ready to learn. SHS works with schools, local authorities and other children's settings to provide personalised support to children and families, tackling the underlying barriers to a successful education to improve the life chances of children.

SHS has also developed an innovative new 'early help' programme that supports both children and parents during transition from home or nursery into primary school and from primary to secondary school. Part of the work involves raising aspirations and helping parents and children understand the link between doing well at school and future employment.

On 19 October 2016, Lancashire took part in an SHS Aspiration Session to introduce the idea of employment in the City of London to a small group of ten year old children from a primary school in south London, providing an insight into the corporate environment. SHS Aspiration Sessions are designed to raise ambitions for future employment and to overcome any misconceptions and fears that children (and their parents) have around working within a corporate environment.

"It was really helpful for the children to hear what the Lancashire employees' jobs involve on a daily basis and what it is like to be working for the Lancashire Group. I would also like to take this opportunity to thank them for answering all of the children's and adults' questions. They were extremely patient with us and gave explanations that the children could really understand."

Tracy, SHS Practitioner

"Thank you for the amazing trip and I thoroughly enjoyed it and definitely enjoyed looking at London's amazing architecture. I would love to visit the building again and hope your company does well in the future. I loved the gift as well."

Boy – aged ten

"Thank you for making our trip unforgettable. I know that I want to visit Lancashire Insurance Group again because of how you made it enjoyable and interesting. Plus you gave an amazing gift bag. You made me start to think more about my future. Thank you."

Girl – aged ten

Paul Russell and Louise Byrne with the primary school children who took part in the School Home Support Aspiration Session.

CORPORATE RESPONSIBILITY IN ACTION

Project Transform

Every year, since 2010, six to eight employees from across the Group volunteer to travel to the Philippines and work alongside ICM for a week providing aid and support to those living in ultra-poverty. The 2016 Project Transform volunteers have reflected on their experience and summarised their thoughts below:

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members of staff have volunteered to participate in ICM's Project Transform in the Philippines since 2010.

"The Project Transform trip is well known amongst Lancashire employees as the experiences of previous participants are shared with such enthusiasm. However, being part of the trip first hand is another thing entirely.

The communities we visited, in spite of having so many limitations in terms of food, shelter and opportunity, were incredibly friendly, positive and determined, and exceptionally humbling to be around. The tireless and selfless work of the ICM staff was also eye-opening, and there is a real focus not just at making improvements for people within the communities in the short term, but also at creating an overall environment in which long-term progress can be made – through education, cooperation and ongoing support.

We returned from the trip feeling honoured to have been selected, and hopeful that our individual and combined contributions helped improve, in some way, the lives of people less privileged than ourselves."

The 2016 Project Transform team pictured from left to right – Mark Carvalho, Alannah Brown, Edward Pycraft, Caroline Palmer, Chris Sharkey, Vikram Singh, Andrew Kemp and Richard Lopez.

ENVIRONMENT

Despite a small increase in reporting scope, total emissions for 2016 have decreased by 9.0 per cent compared to 2015, with emissions per full-time employee (FTE) falling by 12.2 per cent.

With operations in London and Bermuda, and with clients and brokers around the globe, the Lancashire Group incurs the bulk of its carbon footprint as a result of airline travel, which is offset through an organised programme. The Group operates out of two offices, at 20 Fenchurch Street, London, and in Bermuda. The Group is also responsible for an apartment in Bermuda, which is used for temporary accommodation, for which data has been collected and reported for the first time this year.

Types of Emissions	Activity	**2016 tCO_2e**	2015 tCO_2e
Direct (Scope 1)	Gas (kWh)	**90.5**	60.4
	Refrigerant	**0.0**	0.0
Indirect (Scope 2)	Electricity (kWh)	**488.5**	590.2
Indirect (Scope 3)	Business Travel (km)	**1,624.3**	1,754.4
	Additional Upstream Activities	**308.7**	346.6
	Other	**50.3**	63.7
Gross emissions		**2,562.3**	2,815.3
Gross emissions tCO_2e per FTE		**12.9**	14.7
Carbon Credits		**(2,563)**	(2,816)
Net emission after offset		**-**	-

OUR APPROACH

The figures in this report are calculated over a 12-month period from 1 January 2016 to 31 December 2016. Lancashire uses the number of full-time employees (FTE) as its intensity metric, which this year shows a decrease of 12.2 per cent to 12.9 tCO_2e per FTE, compared to 14.7 tCO_2e per FTE in 2015.

Where data was not available for 2016, values have been extrapolated by using available data or calculated using industry benchmarks.

OUR FOCUS AREAS

Using an operational control approach, Lancashire assessed its boundaries to identify all of the activities and facilities for which it is responsible and reported on all of the material Greenhouse Gas (GHG) emissions including Scope 1, 2 and 3. Calculations performed follow the ISO-14064-1:2006 standard and give absolute and intensity factors for the Group's emissions.

The Group's UK operations recently achieved BREEAM excellence for the offices at 20 Fenchurch Street, which has supported an overall improvement in environmental performance.

Therefore, results show that GHG emissions in the year were 2,562.3 tonnes of CO_2e, comprised of direct emissions (Scope 1) amounting to 90.5 tonnes of CO_2e, and indirect emissions (Scope 2) amounting to 488.5 tonnes of CO_2e. The source of other indirect emissions (Scope 3) comprised 1,983.3 tonnes of CO_2e. Scope 2 emissions decreased by 17.2 per cent compared with 2015 due to a 7.2 per cent reduction in overall consumption and the decarbonisation of the UK power grid. Scope 3 emissions have also decreased compared with 2015 due to a reduction in air travel, most notably domestic and short haul flights. Scope 1 emissions have increased by 49.8 per cent due to 2016 being a colder year than 2015, resulting in an increase in gas usage at the Fenchurch Street office.

Lancashire has purchased carbon credits to reduce its gross GHG emissions by 2,562.3 tonnes, offsetting its total carbon emissions and remaining carbon neutral.

The Group has chosen to offset its carbon emissions with Carbon Clear by buying credits in a project to supply low-smoke cooking stoves to communities in the Darfur region of Sudan. These offsetting proposals were discussed and agreed with the Group's CEO.

MARKETPLACE

We continue to help the development of our marketplace by making employees available to sit on market committees, boards and working groups. In 2016, our employees have given talks at industry conferences, investor days and symposia, and market education programmes. As noted on page 37, we also donate to many of the causes supported by our industry partners through the Foundation.

OUR APPROACH

We believe the most important thing we can do is to make the talents of our people available, and we do this happily. We also engage actively with our regulators in Bermuda and London, and the Cathedral team is active within the Lloyd's market. With our clients and their brokers, we are happy to welcome them to our offices, but we also travel to see them and their businesses all around the world.

OUR FOCUS AREAS

Regulators: we recognise the need to engage closely with our regulators at the PRA, FCA, BMA and at Lloyd's and seek to be transparent in all our dealings with them.

Clients: we strive to offer clear, fairly priced and useful products that meet their needs across our range of underwriting operations.

Brokers: we are fully committed to supporting a 'broker market' and prize our broker relationships very highly, right across the Group.

Investors: we continue to work hard at investor relations and have an active programme of engagement with investors around the globe.

WORKPLACE

We strive to attract and retain excellent employees who drive our appetite to outperform. Every company says it, but we truly believe that the talents of our people and our unique culture set us apart from our competitors.

Recruiting the right people for the Group will always be a high priority for the business. It is critical that the aspirations and values of new recruits are a good match to both the role and the values of Lancashire.

The Group promotes an inclusive environment that recognises and values diversity as key to enhancing individual development and maximising business effectiveness. One way in which we seek to increase diversity, and promote the values of the Group, is through our 'Respect in the Workplace' training sessions which are given to all new employees during their induction. The training sessions aim to highlight their responsibilities in preventing discrimination in the workplace and in fostering a positive and productive working environment.

Compulsory training is provided to new permanent staff and fixed term contract staff in relation to a number of topics as follows:

- Tax/Regulatory Operating Guidelines;
- Disclosure (including share dealing);
- Inspections;
- Financial Crime;
- ERM; and
- Communications etiquette.

Other training may be held on an ad hoc, one-off or refresher basis.

CORPORATE RESPONSIBILITY IN ACTION

Internship Programme

In 2014, both the Group and the Foundation jointly sponsored two internship positions for Bermuda resident college graduates. These graduates were afforded the opportunity to spend two years working and learning about insurance in the Group's London office and completed their placements during 2016. One of these graduates is now a full-time employee within Lancashire and the other has obtained a role at another market insurer in Bermuda. The Group is pleased to confirm that we have welcomed one further graduate in the summer of 2016.

Andrew Fleming, Intern

"The opportunities afforded to me in being selected for the Lancashire Foundation Graduate Development Programme have thus far proven themselves to be boundless. Through Lancashire Group's international presence, I am able to both grasp a firm understanding of how the Bermuda market functions, as well as explore the dynamic London market – all while building the skills that I will need to be successful in the (re)insurance industry. This, combined with a company culture that encourages questions and champions open communication, has made it both incredibly easy and interesting to learn about the different aspects of the business. Indeed, though underwriting comes first at Lancashire, the exposure to the greater picture that the rotation in the Lancashire Foundation Graduate Development Programme offers, provides a sound foundation from which I can launch my career and a future that is geared towards success."

The training is designed to ensure that all personnel who are employed by the Group are provided with the skills, knowledge and expertise appropriate to their responsibilities.

Among the full-time staff, the turnover for the Group for 2016 was 20.1 per cent (an increase from 8.9 per cent in 2015), and as at 31 December 2016, 13.1 per cent of the workforce was composed of third-party contractors, an increase from 3.5 per cent in 2015. The relatively high rate of staff turnover and third-party contractors was driven principally by changes in our Lloyd's platform, where there was a process of refreshment and renewal implemented during the year (see the CEO statement and Chairman's governance introductory statement on pages 14 and 42 for further discussion).

Lancashire complies with all relevant local Bermudian and UK legal requirements, in particular with respect to rights of freedom of association, collective bargaining and working time regulations.

OUR FOCUS AREAS

Our focus in 2016 has been to maintain the success of our employees through ongoing training and coaching – provided both internally and externally. During 2016 almost 32 per cent of our employees undertook formal training supported by the Group. We continue to measure our employees' success through attainment of personal performance metrics as well as performance within the Group's values framework. We are delighted that during 2016 approximately 9.6 per cent of our employees were promoted within the Group supported by the training and development opportunities provided. An area for further development during 2017 will be greater standardisation of the appraisal and training frameworks across the Group.

EMBRACING DIVERSITY

We are committed to being an equal opportunities employer. The Group is currently represented by employees from ten different nations. The gender split of males to females (see page 56) within the Group is 61/39 per cent respectively.

Recruiting the right people for the Group is a high priority for the business and we promote the value of having a diverse workforce. We base all recruitment decisions on the ability of our prospective employees to do the job, without consideration to race, age, gender, sexual orientation, disability, beliefs, or background.

CORPORATE RESPONSIBILITY IN ACTION

Bermuda Zoological Society

The Bermuda Zoological Society ('BZS') is the support charity for the Bermuda Aquarium, Museum & Zoo ('BAMZ'). Their mission statement is: *"The shared mission of BAMZ and the BZS is to inspire appreciation and care of island environments. We fulfill our mission through our animal habitat exhibits, which focus on species from oceanic islands, as well as related environmental education, conservation projects and research programmes."*

On 16 September 2016 Bermuda staff spent their annual day of giving on Trunk Island, the BZS living classroom and nature reserve. In 2015, BZS purchased a 2.4 acre lot on the island and have spent considerable time creating a comprehensive restoration plan under the guidance of Dr David Wingate. He is a well known Bermudian ornithologist, naturalist and conservationist and under his direction the staff culled invasive species as well as performed general landscaping tasks.

"Trunk Island provides numerous and unique educational opportunities for Bermuda school students and the community. However, it does require significant people power to maintain and improve the island. We at the Bermuda Zoological Society could not do it without the support of our corporate community. The Lancashire Group has been a major supporter of this project and we are very grateful for everything that they have helped us with. We look forward to working with them in the future and showing the many improvements that they helped to make happen!"

Dr Ian Walker, Principal Curator

"Thank you to the Lancashire Group for their support of Trunk Island. You accomplished a lot and kept our staff and volunteers busy with your enthusiasm and commitment. Please come back again!"

Joanne Chrisnall, Volunteer Co-ordinator

Lancashire Bermuda staff at their annual day of giving on Trunk Island.