lancashire
INSURANCE COMPANY (UK) LIMITED

Responsive in every environment

Solvency & Financial Condition Report 2017

CONTENTS

This executive summary outlines material changes over the reporting period. Note that due to the different presentation bases between IFRS and Solvency II in a number of areas including: the calculation of insurance technical provisions; the eligibility of Own Funds; and line of business segmentation, amongst others, the numbers presented in this report are not all comparable to those published in the Company's financial statements as at 31 December 2017. Override commission received is included in the expense ratio for presentation in the financial statements whereas for Solvency II reporting it is included in the net acquisition cost ratio.

BUSINESS AND PERFORMANCE

The Company is a specialty, short-tail insurer and reinsurer writing business across five Solvency II lines of business: marine, aviation and transport insurance; fire and other damage to property insurance; credit and suretyship; non-proportional property reinsurance; and non-proportional marine, aviation and transport insurance. There have been no significant strategic changes in the Company's business during 2017.

Gross written premiums decreased by $18,400,000 from $250,700,000 for the year ended 31 December 2016 to $232,300,000 for the year ended 31 December 2017. Net retained premium as a percentage of gross written premium for the year ended 31 December 2017 is 13.7%, compared to 13.5% for the year ended 31 December 2016, reflecting a reduction in the quota share reinsurance to LICL a fellow subsidiary company from the beginning of the 2016 underwriting year. Net earned premium remained broadly consistent at $37,100,000 for the year ended 31 December 2017 when compared to $38,100,000 for the year ended 31 December 2016. During 2017, the Company's losses incurred included an estimated gross loss of $16,400,000 (net loss $3,100,000) in relation to hurricanes Harvey, Irma and Maria. Other losses in the year included gross deterioration of $21,800,000 (net loss $nil) on the prior year damage to the turret mooring system on a floating production, storage and offloading oil platform and a low number of other small risk losses. Despite these claims, the net loss ratio of 27.5% compared to 28.6% for the year ended 31 December 2016 reflecting the low level of other losses, reductions in prior year notified losses and also prior year reserve releases in incurred but not reported claims. Favourable development in relation to prior years amounted to $10,600,000 on a gross basis and $6,900,000 net of reinsurance, compared to $25,600,000 on a gross basis and $4,500,000 net of reinsurance in the year ended 31 December 2016. The net acquisition cost ratio, excluding override commission received on the quota share reinsurance agreement with the Company's affiliate LICL, is 55.8% compared to 68.6% in the previous year. The gross general and administrative expense ratio for the year ended 31 December 2017 is 8.7% (2016 – 10.4%). The ratio has decreased mainly due to a $7,400,000 reduction in expenses during the year. On a net basis, the expense ratio which takes into account the override commission received under the LICL quota share agreement is 16.5% (2016 – 30.7%) with the decrease in the current year being mainly due to the $7,400,000 reduction of expenses noted above.

SYSTEM OF GOVERNANCE

The Lancashire group strives to implement simple yet effective systems of corporate governance in a way which helps shape strategy, monitors its implementation, balances support and challenge for management and the business and embeds a positive and open corporate culture throughout the Group. The LUK Board aligns its systems of corporate governance with that of the Group where applicable.

Good strategic debate and decision making remain central to the work of any board. At LUK we are fortunate in having a nimble strategy and a simple "flat" structure with a total employee headcount at 31 December 2017 of 83. This means that all our Directors have regular opportunities to meet with both the members of our management team and other employees within the business. That helps inform our Board's active understanding of the business, its needs and challenges.

Further to the requirements of Solvency II, UK regulated insurers are required to prepare an ORSA report. Both the management team and the Board at the Company have engaged fully with the ORSA process, and use it as a tool to help deepen our understanding of our business, better understand the risks and opportunities facing it and to refine and focus LUK's strategic thinking and priorities.

LUK is part of the Lancashire Group ("LHL" or "the Group"), which includes the companies in the chart shown in section A (E) below, which seeks to achieve the highest standards of corporate governance. As a premium-listed company on the LSE, the Group measures its corporate governance compliance against the requirements of the UK Corporate Governance Code published by the UK FRC. The Group has a robust Board and Committee structure. The Board Committees of LHL comprise Audit, Investment, Nomination and Corporate Governance, Underwriting and Underwriting Risk and Remuneration Committees. LUK has its own Audit and Remuneration committees, the other committees are Group committees which provide services and / or reports to the LUK Board. LUK also has an Executive Management Committee and a Regulatory Reporting and Oversight Committee. Certain matters are reserved for the Board such as strategy, internal controls and risk. Details of Board Committees and key functions are provided in section B.1.

There have been no changes to the Company's governance structure during the year.

RISK PROFILE

The Group is exposed to risks from several sources. These include insurance risk, market risk, liquidity risk, credit risk, operational risk and strategic risk. The primary risk to the Company is insurance risk. There were no changes to the Company's key risk areas in 2017. Each of these risk areas is described in more detail in section C below.

VALUATION FOR SOLVENCY PURPOSES

Apart from some balance sheet reclassifications and valuation adjustments required for determining reinsurance recoverables and technical provisions, there are no differences between the bases, methods and main assumptions used in valuing assets and liabilities for Solvency II purposes compared to those used in the Company's financial statements that are prepared in accordance with accounting principles generally accepted under IFRS as adopted by the EU.

The valuation of technical provisions for Solvency II moves from an IFRS 'best estimate' basis to a discounted cashflow approach. IFRS provisions include the earned provisions relating to events which have occurred at the valuation date (whether reported or not) and associated loss adjustment expenses, plus non-monetary items corresponding to 100% of the unearned premium less an allowance for the acquisition costs already paid on this unearned premium. Solvency II then adjusts the above basis to move to a discounted cashflow approach (claims, expenses and premiums) on a legally obliged (rather than inception) basis allowing for the expected value of all possible outcomes. This removes the non-monetary items and replaces these with the cashflows expected to arise from these exposures, including business to which the Company is legally obliged to accept but is yet to incept.

Detailed explanations and reconciliations from the assets and liabilities presented in the Company's financial statements as at 31 December 2017 to those presented on a Solvency II basis in this report are included in Section D below. There were no significant changes to the Company's Solvency II valuation methodology during 2017.

CAPITAL MANAGEMENT

LUK, as a wholly owned subsidiary company falls within the Group's capital management process.

The key aim of the Group's 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 Company's own funds are comprised of Tier 1 capital items totalling $180,218,000 as at 31 December 2017. Tier 1 capital is the highest quality capital under Solvency II with the greatest loss absorbing capacity, comprising share capital and retained earnings. There have been no changes to the profile of the components of the Company's own funds during the year ended 31 December 2017 and the own funds remain wholly eligible to meet the regulatory capital requirements being the Solvency Capital Requirement ('SCR') and the Minimum Capital Requirement ('MCR').

The Company uses the standard formula to calculate its SCR which amounted to $87,290,000 at 31 December 2017. The SCR, analysed by risk module, is set out in section E.2. The Company's Own Funds exceeded the SCR by $92,928,000 at 31 December 2017, resulting in a coverage ratio of 206.5%. The Company met its regulatory capital requirements at all times during the year.

There were no significant changes to the Company's capital management strategy during 2017.

DIRECTORS' STATEMENT

We acknowledge our responsibility for preparing the Company's SFCR in all material respects in accordance with the PRA Rules and the Solvency II Regulations.

We are satisfied that:

a) throughout the financial year in question, the Company has complied in all material respects with the requirements of the PRA Rules and the Solvency II Regulations as applicable; and

b) it is reasonable to believe that the Company has continued so to comply subsequently and will continue so to comply in future.

Paul Gregory	Russell Worsley
Director	Director

26 April 2018

Date

Report of the external independent auditor to the Directors of Lancashire Insurance Company (UK) Limited pursuant to Rule 4.1 (2) of the External Audit Chapter of the PRA Rulebook applicable to Solvency II firms

Report on the Audit of the Relevant Elements of the Solvency and Financial Condition Report

Opinion

Except as stated below, we have audited the following documents prepared by Lancashire Insurance Company (UK) Limited ('the Company') as at 31 December 2017:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report of the Company as at 31 December 2017, ('**the Narrative Disclosures subject to audit**'); and
- Company templates S02.01.02, S17.01.02, S23.01.01, S25.01.21, S28.01.01 ('**the Templates subject to audit**').

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the '**Relevant Elements of the Solvency and Financial Condition Report**'.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on the Other Information which comprises:

- The 'Business and performance', 'System of governance' and 'Risk profile' elements of the Solvency and Financial Condition Report;
- Company templates S05.01.02, S05.02.01, S19.01.21;
- the written acknowledgement by management of their responsibilities, including for the preparation of the Solvency and Financial Condition Report ('**the Responsibility Statement**').

In our opinion, the information subject to audit in the Relevant Elements of the Solvency and Financial Condition Report of the Company as at 31 December 2017 is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as modified by relevant supervisory modifications, and as supplemented by supervisory approvals and determinations.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)), including ISA (UK) 800 and ISA (UK) 805, and applicable law. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Relevant Elements of the Solvency and Financial Condition Report* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the Solvency and Financial Condition Report in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter – special purpose basis of accounting

We draw attention to the 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report, which describe the basis of accounting. The Solvency and Financial Condition Report is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The Solvency and Financial Condition Report is required to be published, and intended users include but are not limited to the Prudential Regulation Authority. As a result, the Solvency and Financial Condition Report may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you if:

- the directors' use of the going concern basis of accounting in the preparation of the SFCR is not appropriate; or
- the directors have not disclosed in the SFCR any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the SFCR is authorised for issue.

Other Information

The Directors are responsible for the Other Information.

Our opinion on the Relevant Elements of the Solvency and Financial Condition Report does not cover the Other Information and, accordingly, we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the Solvency and Financial Condition Report, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the Relevant Elements of the Solvency and Financial Condition Report, or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the Relevant Elements of the Solvency and Financial Condition Report or a material misstatement of the Other Information. If, based on the work we have performed, we conclude that there is a material misstatement of this Other Information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Directors for the Solvency and Financial Condition Report

The Directors are responsible for the preparation of the Solvency and Financial Condition Report in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations.

The Directors are also responsible for such internal control as they determine is necessary to enable the preparation of a Solvency and Financial Condition Report that is free from material misstatement, whether due to fraud or error; assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of the Relevant Elements of the Solvency and Financial Condition Report

It is our responsibility to form an independent opinion as to whether the Relevant Elements of the Solvency and Financial Condition Report are prepared, in all material respects, with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as modified by relevant supervisory modifications, and as supplemented by supervisory approvals and determinations.

Our objectives are to obtain reasonable assurance about whether the Relevant Elements of the Solvency and Financial Condition Report are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decision making or the judgement of the users taken on the basis of the Relevant Elements of the Solvency and Financial Condition Report.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities.

Report on Other Legal and Regulatory Requirements

In accordance with Rule 4.1 (3) of the External Audit Chapter of the PRA Rulebook we are required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of Lancashire Insurance Company (UK) Limited's statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

The purpose of our audit work and to whom we owe our responsibilities

This report of the external auditor is made solely to the company's directors, as its governing body, in accordance with the requirement in Rule 4.1(2) of the External Audit Part of the PRA Rulebook and the terms of our engagement. We acknowledge that the directors are required to submit the report to the PRA, to enable the PRA to verify that an auditor's report has been commissioned by the company's directors and issued in accordance with the requirement set out in Rule 4.1(2) of the External Audit Part of the PRA Rulebook and to facilitate the discharge by the PRA of its regulatory functions in respect of the company, conferred on the PRA by or under the Financial Services and Markets Act 2000.

Our audit has been undertaken so that we might state to the company's directors those matters we are required to state to them in an auditor's report issued pursuant to Rule 4.1(2) and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company through its governing body, for our audit, for this report, or for the opinions we have formed.

Timothy Butchart

for and on behalf of KPMG LLP

15 Canada Square

London E14 5GL

26 April 2018

- The maintenance and integrity of Lancashire Insurance Company (UK) Limited's website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the Solvency and Financial Condition Report since it was initially presented on the website.
- Legislation in the United Kingdom governing the preparation and dissemination of Solvency and Financial Condition Reports may differ from legislation in other jurisdictions.

Appendix – relevant elements of the Solvency and Financial Condition Report that are not subject to audit

Solo standard formula

The Relevant Elements of the Solvency and Financial Condition Report that are not subject to audit comprise:

- The following elements of template S.12.01.02
  - Rows R0110 to R0130 – Amount of transitional measure on technical provisions
- The following elements of template S.17.01.02
  - Rows R0290 to R0310 – Amount of transitional measure on technical provisions
- The following elements of template S.22.01.21
  - Column C0030 – Impact of transitional on technical provisions
- Elements of the Narrative Disclosures subject to audit identified as 'unaudited'.

A BUSINESS AND PERFORMANCE

A1: BUSINESS

(A) NAME AND LEGAL FORM

LUK is a provider of global specialty insurance and reinsurance products with an emphasis on property, energy, marine and aviation lines of business. The Company is authorised by the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA") to conduct general insurance business. The Company received UK regulatory authorisation to underwrite business on 30 August 2006 and commenced underwriting activity on 2 October 2006. The Company is also registered as a Class 3 general insurer in Bermuda and has a permit issued under the Bermuda Companies Act to enable certain activities related to its insurance business to be performed from Bermuda. Its registered office is at Level 29, 20 Fenchurch Street, London, EC3M 3BY, United Kingdom.

The Company is a wholly owned subsidiary of LHL whose registered office is Power House, 7 Par-la-Ville Road, Hamilton HM 11, Bermuda. LHL's head office is at Level 29, 20 Fenchurch Street, London, EC3M 3BY, United Kingdom. LHL's common shares are traded on the main market of the LSE and it also has a secondary listing on the BSX.

(B) SUPERVISORY AUTHORITY AND GROUP SUPERVISOR

LUK's supervisory authority is the PRA in the UK, London Markets, Insurance Division, Prudential Regulation Authority, Bank of England, 20 Moorgate, London, EC2R 6DA.

(C) EXTERNAL AUDITOR

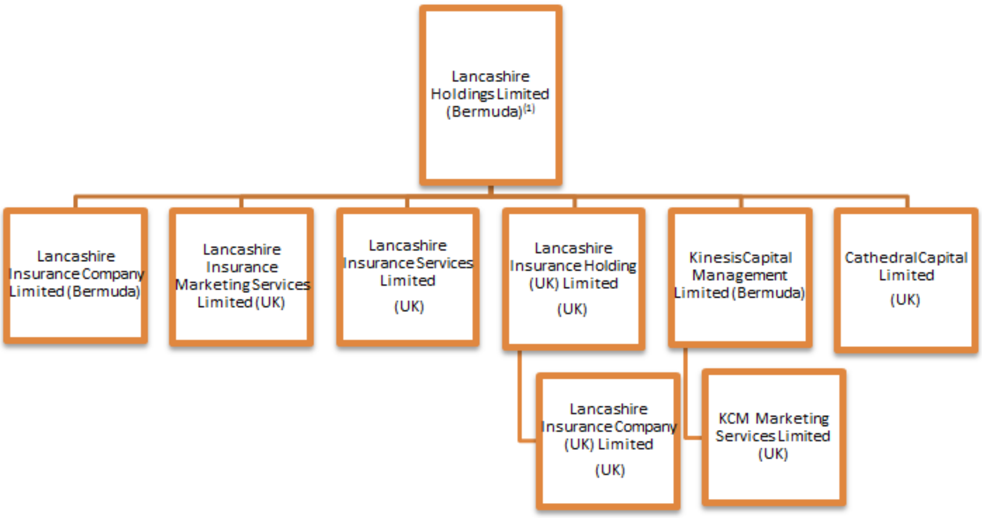
LUK's current external auditor is KPMG LLP, 15 Canada Square, London, E14 5GL.

(D) HOLDERS OF QUALIFYING HOLDINGS

LUK is a wholly owned subsidiary undertaking of LHL.

(E) POSITION WITHIN THE LEGAL STRUCTURE OF THE GROUP

The Group's structure is summarised in the chart below, including country of incorporation:



(1) All ownership interests are 100% except for Kinesis Capital Management Limited which is 92.7% owned by Lancashire Holdings Limited.

(F) MATERIAL LINES OF BUSINESS

The Company writes five classes of Solvency II lines of business: marine, aviation and transport insurance; fire and other damage to property insurance; credit and suretyship; non-proportional property reinsurance and non-proportional marine, aviation and transport insurance. All business is underwritten in the United Kingdom and risks covered are worldwide. Further detail of business written by geographical area is disclosed in section A2(B) below.

(G) SIGNIFICANT EVENTS

There have been no significant business or other events that have occurred over the reporting period that have had a material impact on the undertaking.

A2: UNDERWRITING PERFORMANCE

(A) UNDERWRITING PEFORMANCE BY LINE OF BUSINESS

The Company's underwriting performance on an IFRS basis, by Solvency II line of business,is summarised in the tables below. As the Solvency II prescribed lines of business are different from the Company's defined business segments, the results below are not directly comparable to those disclosed in LUK's 2017 financial statements.

For the year ended 31 December 2017	Marine, aviation and transport insurance $'000	Fire and other damage to property insurance $'000	Credit and suretyship insurance $'000	Non-proportional property insurance $'000	Non-proportional marine, aviation and transport insurance $'000	Total $'000
Gross premiums written	158,949	30,365	22,281	6,610	14,081	232,286
Outwards reinsurance premiums	138,015	25,184	20,662	5,377	11,300	200,538
Net premiums earned	26,106	6,308	1,984	1,332	1,331	37,061
Gross claims incurred	52,762	5,701	4,208	12,047	4,510	79,228
Claims recoverable	47,534	4,622	3,478	9,804	3,608	69,046
Net claims incurred	5,228	1,079	730	2,243	902	10,182
Net expenses incurred(1)	8,146	342	(1,389)	(851)	(206)	6,042
Underwriting performance	**12,732**	**4,887**	**2,643**	**(60)**	**635**	**20,837**

(1) Acquisition cost expenses including override commission received on outwards reinsurance contracts

For the year ended 31 December 2017	Marine, aviation and transport insurance %	Fire and other damage to property insurance %	Credit and suretyship insurance %	Non-proportional property insurance %	Non-proportional marine, aviation and transport insurance %	Total %
Net loss ratio	20.0	17.1	36.8	168.4	67.8	27.5
Net acquisition expense ratio	31.2	5.4	(70.0)	(63.9)	(15.5)	16.3

For the year ended 31 December 2016	Marine, aviation and transport insurance $'000	Fire and other damage to property insurance $'000	Credit and suretyship insurance $'000	Non-proportional property insurance $'000	Non-proportional marine, aviation and transport insurance $'000	Total $'000
Gross premiums written	186,088	36,503	24,242	3,576	332	250,741
Outwards reinsurance premiums	162,143	32,981	18,516	2,913	283	216,836
Net premiums earned	27,766	5,638	3,846	735	100	38,085
Gross claims incurred	106,671	9,418	(1,146)	1,804	40	116,787
Claims recoverable	97,460	7,851	(956)	1,497	33	105,885
Net expenses incurred(1)	9,211	1,567	(190)	307	7	10,902
Net expenses incurred	11,806	(354)	(1,040)	(617)	15	9,810
Underwriting performance	**6,749**	**4,425**	**5,076**	**1,045**	**78**	**17,373**

(1) Acquisition cost expenses including override commission received on outwards reinsurance contracts

For the year ended 31 December 2016	Marine, aviation and transport insurance %	Fire and other damage to property insurance %	Credit and suretyship insurance %	Non-proportional property insurance %	Non-proportional marine, aviation and transport insurance %	Total %
Net loss ratio	33.2	27.8	(4.9)	41.8	7.0	28.6
Net acquisition expense ratio	42.5	(6.3)	(27.0)	(83.9)	15.0	25.8

Despite the continuing soft market during 2017 the Company was able to generate an underwriting profit of $20,837,000, before taking into account operating expenses. The Company's overall loss ratio was 27.5% reflecting the low level of material losses, reductions in prior year notified losses as well as prior year releases in IBNR. In addition the Company's net acquisition cost ratio, after taking into account override commission on an intergroup quota share reinsurance, was 16.3%.

Our strategy has remained unchanged – we are working to maintain our long term profitable underwriting relationships whilst managing our exposure through the purchase of well-priced, targeted reinsurance.

(I) MARINE, AVIATION AND TRANSPORT INSURANCE AND NON-PROPORTIONAL MARINE, AVIATION AND TRANSPORT INSURANCE

This class of business includes the majority of our energy, marine and aviation segments.

In the energy market, the low oil price and historically high levels of upstream energy market capacity witnessed during 2015 and 2016 continued in 2017, albeit with an oil price that was far more stable and a client base whose necessary cost cutting had largely been achieved. The stabilisation of the oil price meant that the demand side of the equation held up during 2017. Whilst the upstream energy market did not see a huge uptick in demand there were not any further reductions and there are a few early signs of some demand coming back into the system with a small number of construction projects coming to market and a number of our clients gradually increasing activity.

With the supply dynamic unchanged, i.e. historically high levels of market capacity, there was still pressure on rates as competition for a much reduced pot of premium continued amongst markets. The Company's strategy has been to maintain our core portfolio of profitable business as rates are now approaching levels last seen in the late 1990s and, considering that in 2012 rates were not far from historical highs, this shows how steep the fall in energy rates has been in the space of only a few years.

2017, however, was relatively benign for the upstream energy market in terms of significant claims although some prior year major losses did develop negatively, highlighting the volatility of the class. This benign loss year has helped mask the underlying weakness of energy rates and any return to a 'normalised' loss year would likely render the current rating environment unsustainable from a macro-market perspective. Whilst the natural catastrophe events of 2017 have not directly impacted the upstream energy market they are large enough to alter the direction of the energy reinsurance market, which will filter through to the direct market as reinsurance costs increase. With this dynamic in place we fully expect market conditions to improve during 2018. The Company has access to energy business which primarily will focus on servicing existing clients' needs. However, should market conditions dictate, we have the people and the platforms to grow our energy portfolio further.

The marine market was relatively stable during 2017 with rates across areas of our marine portfolios remaining reasonably static. Our hull, builders' risk and ancillary marine products portfolio performed steadily and we maintained our position on all our key accounts. This portfolio has been our most stable since our inception with our risk appetite clearly defined, which has allowed us to deliver sector-leading results for what is a notoriously difficult area to generate underwriting returns.

The AV52 aviation portfolio remains stable and once again performed profitably, despite pressure on rating, given the extremely low claims frequency for this class.

(II) FIRE AND OTHER DAMAGE TO PROPERTY INSURANCE

This class of business largely comprises our terror, political violence and political risk books.

As in recent years the world continued to be a volatile place during 2017. There were numerous terrorist attacks across the globe in cities including London, Manchester, Barcelona, Paris and Stockholm as well as ongoing wars and civil disruption in many countries including Syria, Libya, Afghanistan, Iraq and Yemen. In addition, we have seen political tensions escalate between North Korea and the U.S. with the sabre-rattling intensifying. Despite these terrorism events and wars being horrific from a loss of life perspective, the impact on the insurance market has been minimal as they have created very few actual insured losses.

This global political and socio-economic climate certainly creates challenges for underwriting these classes of business, and risk selection remains absolutely crucial as years of softening rates means that there is little margin to cater for any type of attritional losses. Given this, and as with other classes of business, we have built up a profitable core portfolio of business, which in the softer market we have successfully retained. If the significant loss events of 2017 lead to a broader hard market then our leadership capabilities in these classes would allow us to develop our portfolio quickly and we have the appetite to do so.

The Company is able to offer significant capacity across multiple platforms to ensure we are providing both clients and brokers with fully rounded products and service which allows us to maintain our underwriting principles despite the many challenges the market contains.

(III) CREDIT AND SURETYSHIP INSURANCE

This class of business largely comprises our sovereign obligors book of business.

Sovereign and quasi-sovereign obligors coverage protects against the non-payment or non-honouring of an obligation by a sovereign or quasi-sovereign entity. Cover is provided to medium to large commercial and industrial clients as well as bank and commodity trading clients. The term of these contracts is often multi-year reflecting the term of the underlying exposures. This cover generally relates to one-off bespoke deals and is not a renewing book – premium income therefore tends to be unpredictable.

(IV) NON-PROPORTIONAL PROPERTY INSURANCE

This class of business is immaterial for LUK in terms of gross written premium but comprises a small amount of property catastrophe and property retrocession business.

For more detailed quantitative information refer to Appendix 1: S.05.01.01 – premiums/claims/expenses QRT.

(B) UNDERWRITING PEFORMANCE BY GEOGRAPHICAL AREA

The Company's underwriting performance by geographical area is detailed in Appendix 1: S.05.02.01 – premiums/claims/expenses by country QRT. All business is underwritten in the United Kingdom, by LUK, and risks covered are worldwide. LUK writes mostly direct insurance with a leading presence in the energy, terrorism, political risk, marine hull and AV52 markets.

The S.05.02.01 QRT in Appendix 1 discloses underwriting performance by geographical area according to the specific Solvency II requirements for this form and the resulting geographical area splits do not necessarily reflect the location of risk or the location of underwriting. The geographical area for the fire and other damage to property and credit and surety lines of business is the location of risk, for the marine, aviation and transport line of business it is the location where the contract was entered into and for non-proportional business it is the location of the client.

A3: INVESTMENT PERFORMANCE

(A) INVESTMENT INCOME AND EXPENSES

The Company's investment income and expenses by Solvency II asset class are summarised in the tables below:

For the year ended 31 December 2017	Interest income $'000	Net gains and losses $'000	Unrealised gains and losses $'000	Total $'000
Government bonds	621	(95)	64	590
Corporate bonds	1,561	95	(124)	1,532
Collateralised securities	179	20	44	243
Collective investments undertakings	98	–	–	98
Cash and cash equivalents	20	–	–	20
Total	**2,479**	**20**	**(16)**	**2,483**

For the year ended 31 December 2016	Interest income $'000	Net gains and losses $'000	Unrealised gains and losses $'000	Total $'000
Government bonds	931	172	(226)	877
Corporate bonds	1,595	258	258	2,111
Collateralised securities	225	(42)	(68)	115
Collective investments undertakings	(39)	–	–	(39)
Cash and cash equivalents	(6)	–	–	(6)
Total	**2,706**	**388**	**(36)**	**3,058**

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 2017, our focus has been on managing our interest rate risk, the largest risk to our predominantly fixed maturity portfolio. We continue to maintain a short-duration fixed maturity portfolio. Our portfolio mix illustrates our conservative philosophy. With the composition regulated by the Company's investment guidelines, we have two investment portfolio categories: 'core', 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 either of the two portfolio categories.

(B) INVESTMENT GAINS AND LOSSES RECOGNISED DIRECTLY IN EQUITY

Gains and losses recognised directly in equity comprise the unrealised gains and losses detailed in section A3(A) above.

(C) INVESTMENTS IN SECURITISATION

The Company's allocation to investments in securitisation comprises the following:

As at 31 December	2017 Total $'000	2016 Total $'000
Asset backed securities	4,089	1,748
Non-agency commercial mortgage backed securities	44	707
Non-agency mortgage backed securities	140	797
U.S. government agency mortgage backed securities	4,786	6,675
Total collateralised securities	**9,059**	**9,927**

In both 2017 and 2016 all the collateralised investments are determined as Level (ii) investments in the fair value hierarchy as described on pages 39-40 of LUK's 31 December 2017 financial statements available on the Group's website: Lancashire Insurance Company (UK) Limited.

The total return from these investments for the year ended 31 December 2017 was $243,000 (2016- $115,000).

A4: PERFORMANCE OF OTHER ACTIVITIES

(A) OTHER INCOME

The Company does not have any other income.

(B) OTHER OPERATING EXPENSES

Other operating expenses are summarised in the table below:

For the year ended 31 December	2017 Total $'000	2016 Total $'000
General and administration costs	7,420	6,659
Service fee	14,309	22,428
Costs Reimbursed by fellow Subsidiary	(949)	(1,062)
Total	**20,780**	**28,025**

Service fee expenses were $8,119,000 lower for the year ended 31 December 2017 compared to the same period in 2016 primarily due to lower variable compensation costs due to the catastrophe activity during the year.

(C) EQUITY BASED COMPENSATION EXPENSES

Equity based compensation expenses are recharged as part of the service fee discussed above.

(D) FINANCING COSTS

LUK did not incur any financing costs during the year.

(E) LEASING ARRANGEMENTS

Lease costs are charged to the Company as part of the service fee from the lessor, Lancashire Insurance Services Limited, a fellow group subsidiary company.

A5: ANY OTHER INFORMATION

All material information regarding the Company's business and performance by Solvency II lines of business is disclosed in sections A2 – A4 above.

Transactions within the Group: Intra-Group Reinsurance

LICL and LUK have entered into a whole account quota share agreement ("QST"). Under this agreement LUK cedes a share of all its business written or assumed. During the year the following amounts were ceded from LUK to LICL under the terms of this agreement:

For the year ended 31 December	2017 $'000	2016 $'000
Gross premiums written	**(123,299)**	(145,795)
Change in unearned premiums	**(18,076)**	(26,048)
Insurance losses and loss adjustment expenses	**43,198**	55,785
Insurance acquisition expenses	**56,550**	63,641

LICL holds $245,302,000 (2016 – $290,752,000) (valued on an IFRS basis) of cash and cash equivalents and fixed income securities in trust for the benefit of LUK relating to the intra-group reinsurance agreement.

B.1 GENERAL INFORMATION ON THE SYSTEM OF GOVERNANCE

The Group strives to implement simple yet effective systems of corporate governance in a way that helps shape strategy, monitors its implementation, balances support and challenge for management and the business and embeds a positive and open corporate culture throughout the Group. The LUK Board aligns its systems of corporate governance with that of the Group where applicable.

Good strategic debate and decision making remain central to the work of any board. At LUK we are fortunate in having a nimble strategy and a simple "flat" structure with a total employee headcount at 31 December 2017 of 83. This means that all our Directors have regular opportunities to meet with both the members of our management team and other employees within the business. That helps inform our Board's active understanding of the business, its needs and challenges.

Further to the requirements of Solvency II, UK regulated insurers are required to prepare an ORSA report. Both the management team and the Board have engaged fully with the ORSA process, and use it as a tool to help deepen our understanding of our business, better understand the risks and opportunities facing it and to refine and focus Lancashire's strategic thinking and priorities.

The Group seeks to achieve the highest standards of corporate governance. As a premium listed Group on the LSE, it measures its corporate governance compliance against the requirements of the UK Corporate Governance Code published by the UK FRC. The LUK Board and its committees seek to align their general approach, in relation to the matters that they regularly consider, with that of the LHL Board and committees and their terms of reference as adopted from time to time. There have been no changes to the Company's governance structure during the year.

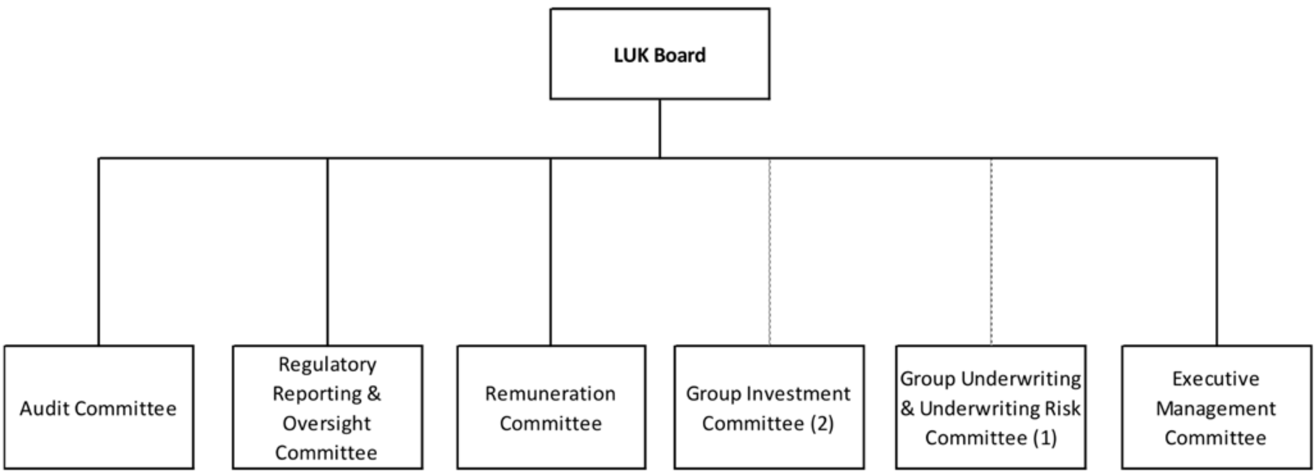
Please refer to the Corporate Governance section starting at page 42 of the Group's 2017 Annual Report and Accounts for additional details on the Group's system of governance, supplementary to that disclosed below: Investors – Lancashire Group.

(A) BOARD AND COMMITTEES

The Board of Directors is responsible for the leadership and control and the long-term success of the business. The Board has reserved a number of matters for its decision, including responsibility for setting the Company's values and standards, and approval of the Company's strategic aims and objectives. The Board is responsible for setting the Company's risk appetites, defining its risk tolerances, and setting and monitoring the Company's risk management and internal control systems including compliance with risk tolerances.

The Board has delegated certain matters to Committees of the Board. There are a number of matters which the Board considers not suitable for delegation including: approval of dividends and dividend policy; receiving reports from the Group Chief Risk Officer ("CRO") and legal and compliance department; approval of the financial statements and accounts and any qualification thereon; approval of significant changes in accounting policy or practice; approval of annual Solvency II regulatory submissions; appointments and removal of directors and the Company Secretary; selection of the Chairman and CEO; committee membership and chairmanship; appointment and removal of external auditors; division of responsibilities between executive and non-executive directors; approval of committee Terms of Reference; receiving committee reports; and determining the independence of directors.

The Company's governance structure is as follows:



(1) does not report directly to the LUK Board, but it establishes the group underwriting strategy in which LUK is an active and significant participant
(2) does not report directly to the LUK Board but it provides services and reports to the LUK Board

The Board carries out its duties in accordance with the Companies Act 2006, other relevant legislation, the company's memorandum and articles of association, resolutions of the Company and the general common law. The Board has established Audit, Regulatory Reporting & Oversight Committees, Executive Management and Remuneration Committees. There is also a Group Investment Committee which provides reports to the LUK Board and a Group Underwriting and Underwriting Risk Committee which, although does not report directly to the LUK Board, it establishes the group underwriting strategy in which LUK is an active and significant participant. Each of the Committees has written Terms of Reference, which are reviewed regularly. The Schedule of LUK Board Reserved Matters and Terms of Reference of the LUK Board Committees can be found on the Group's website at: Lancashire Insurance Company (UK) Limited. The Terms of Reference of the relevant Group committees are on the Group's website at: Board Committees – Lancashire Group. The Committees are generally scheduled to meet quarterly, although additional meetings and information updates are arranged as business requirements dictate. The composition of the Group Committees as at 31 December 2017 was as set out in the table on page 49 of the Group's 2017 Annual Report and Accounts for 31 December 2017: Investors – Lancashire Group and the composition of the LUK Committees is detailed in Appendix 2.

At the regular quarterly Board and Committee meetings, the Directors review all areas of the Company's business and receive reports from management on underwriting, reserving, finance, investments, capital management, internal audit, risk, legal and regulatory developments, compliance and other matters affecting the Company. Management provides the Board with the information necessary for it to fulfil its responsibilities. In addition, presentations are made by external advisers if required. The Board Committees are authorised to seek independent professional advice at the Company's expense.

The Chairman is responsible for the leadership and management of the Board and for providing appropriate support and advice to the CEO. The CEO is responsible for the management of the Company's business and for the development of the Group's strategy and commercial objectives. The CEO is responsible, along with the executive team, for implementing the Board's decisions.

(B) ROLES AND RESPONSIBILITIES OF KEY FUNCTIONS

The Company defines key functions as those prescribed by the relevant regulators as well as those functions which the Company considers to be important within the system of governance. The key functions prescribed by Solvency II are risk management, internal audit, compliance and actuarial. The Company has also defined the following as key functions: finance and investment management, underwriting and reinsurance, claims management and IT.

(I) RISK MANAGEMENT FUNCTION

The risk management function at the Lancashire Group oversees all the Group and subsidiary undertaking risk management duties. The function is led by Louise Wells, CRO, who is a Fellow of the Institute of Chartered Accountants and fulfils the UK regulators' controlled function role of Chief Risk Officer (SIMF4). The CRO reports to the LUK Board and is supported by a number of additional individuals who are deemed to be sufficiently skilled to perform risk management function duties. The risk management function therefore has the required skills, knowledge and expertise to fulfil its duties.

Whilst risk is considered at Board level, committees of the Board have responsibility for various aspects of risk. The CRO reports directly to the Group and subsidiary undertaking Boards (with the exception of Cathedral Underwriting Limited (CUL) where the responsibility falls to the Cathedral CRO) and facilitates and aids the identification, evaluation, quantification, mitigation and control of risks at a Group and subsidiary undertaking level. The CRO provides regular reports to the Group and subsidiary undertaking Boards covering, amongst other things, actual risk levels against tolerances, emerging risks and any lessons learned. The Group Board considers that a supportive Enterprise Risk Management ("ERM") culture, established by the Board and embedded throughout the subsidiary undertakings, is of key importance. Facilitating and embedding ERM, and helping the Group to improve its ERM practices, is a major responsibility assigned to the CRO.

The risk management function is deemed sufficiently independent and has performed its duties in an objective and fair manner. The function has direct access to the LUK Board to report on any matters that may impact its ability to perform its duties effectively

(II) INTERNAL AUDIT FUNCTION

The internal audit function at the Group oversees all the Group and subsidiary undertaking internal audits. The function is led by Steven Hartley, Group Head of Internal Audit (HIA), who is a Fellow of the Institute of Chartered Accountants and fulfils the UK regulators' controlled function role of Head of Internal Audit (SIMF5). The HIA reports to the LHL and LUK Audit Committees and is supported by a number of additional individuals who are deemed to be sufficiently skilled to perform internal audit function duties. The internal audit function has the required skills, knowledge and expertise to fulfil its duties. Internal audit plays a key role in the Group's ERM by providing an independent opinion regarding the accuracy and completeness of risks in the risk register, in addition to verification of the effectiveness of controls and the consistency of their operation.

The internal audit function is deemed sufficiently independent and has performed its duties in an objective and fair manner. The function has direct access to the LUK Board to report on any matters that may impact its ability to perform its duties effectively.

The internal audit function is described more fully in Section B.5 below.

(III) COMPLIANCE FUNCTION

The Group compliance function at Lancashire oversees all the Group and subsidiary undertaking compliance matters. The function is led by John Cadman, Group General Counsel, who reports directly to the LHL Board. Its key responsibilities are to identify, assess, monitor and report on the compliance risks which the Group faces as well as the establishment of a robust compliance framework and assessing the appropriateness of the Group's compliance procedures.

The Group maintains separate compliance functions across its operating entities to ensure it maintains its focus on the specific legal and regulatory issues in each of the operating jurisdictions. Within the UK, the function is led by Michael Connor, LUK General Counsel & Company Secretary, who is a qualified solicitor and fulfils the UK regulators' controlled function role of Compliance Oversight Officer (CF10), Money Laundering Reporting Officer (CF11) and Director of LUK (CF1). The LUK General Counsel reports to the Group General Counsel. The compliance function at both the Group and subsidiary undertaking level is supported by a number of additional individuals who are deemed to be sufficiently skilled to perform compliance function duties. The compliance function has the required skills, knowledge and expertise to fulfil its duties. The compliance function is deemed sufficiently independent and has performed its duties in an objective and fair manner. The function has direct access to the LUK Board via the LUK General Counsel & Company Secretary, to report on any matters that may impact its ability to perform its duties effectively.

The compliance function is described more fully in Section B.5 below.

(IV) ACTUARIAL FUNCTION

The actuarial function at the Lancashire Group oversees all the Group and subsidiary undertaking actuarial duties. Due to the potential conflicts with the Chief Actuary's underwriting duties, the Deputy Chief Actuary holds the position of Actuarial Function lead. Ben Readdy is the Deputy Group Chief Actuary and is a Fellow of the Institute and Faculty of Actuaries (IFoA). Mr Readdy fulfils the UK regulators' controlled function role of Chief Actuary (SIMF20). Further, as required by the IFoA, he also holds a UK Practising Certificate and complies with the additional requirements from the IFoA to maintain this certificate. The Deputy Group Chief Actuary reports to the CRO, for Solvency II reporting, and is supported by a number of additional individuals who are deemed to be sufficiently skilled to perform actuarial function duties. The actuarial function has the required skills, knowledge and expertise to fulfil its duties.

The actuarial function is deemed sufficiently independent and has performed its duties in an objective and fair manner. The function has direct access to the LUK Board to report on any matters that may impact its ability to perform its duties effectively.

(V) INTERNALLY DEFINED KEY FUNCTIONS

The following functional areas have been deemed as important within the system of governance by management. To comply with the UK regulators' SIMR regime each of these areas within LUK has a Controlled Function or SIMF owner. The SIMF owner of these functions and each function's key responsibilities are disclosed below. Each of these functional areas is supported by appropriate resources, both in quantum and in terms of experience and skills, to enable them to perform their duties with the required skill, knowledge and expertise.

FINANCE

The finance function at LUK oversees all the Company's finance and investment management matters. The function is led by Russell Worsley, Finance Director, who is an Executive Director of the LUK Board. Its key responsibilities are: the provision of internal and external financial reporting that complies with the relevant IFRS and regulatory guidelines on a timely basis; capital management; business planning and forecasting; and to ensure that the Company's external investment portfolio is managed in accordance with the Group's investment strategy and Company's investment guidelines and risk parameters.

UNDERWRITING AND REINSURANCE

The underwriting and reinsurance function at LUK oversees all the Company's underwriting and reinsurance management matters. The function is led by Hayley Johnston, Chief Underwriting Officer, who reports to the LUK CEO, Paul Gregory and is also an Executive Director of the LUK Board. Its key responsibilities are to ensure that the Company's inwards and outwards (re)insurance business is managed in accordance with the Group's strategy and risk appetite.

CLAIMS MANAGEMENT

The claims management function at LUK oversees all the Company's claims management matters. The function is led by Steve Yeo, Group Head of Claims, who reports directly to the Group General Counsel and is an Executive Director of the LUK Board. Its key responsibility is to ensure that the Company pays all valid claims in a timely manner and in accordance with the relevant (re)insurance contract of the policyholder.

IT

The IT function oversees all the Company's IT matters. The function is led by Paul Gregory, Group Chief Underwriting Officer, and LUK CEO, who reports to the Group CEO, Alex Maloney and is also an Executive Director of the LUK Board, assisted by the Group Head of IT, Jed Farr. Its key responsibilities are to deliver IT services and support in alignment with Lancashire's corporate strategy.

(C) ANY MATERIAL CHANGES IN THE SYSTEM OF GOVERNANCE THAT HAVE TAKEN PLACE OVER THE REPORTING PERIOD

There have been no material changes in the system of governance during the reporting period.

(D) REMUNERATION POLICY AND PRACTICES

Detailed information concerning the Group's and subsidiary undertakings remuneration policies and practices can be found on pages 60-79 of the Group's 2017 Annual Report and Accounts: Investors – Lancashire Group

(I) REMUNERATION POLICY PRINCIPLES

The Group's goal continues to be to reward its employees fairly and responsibly, by providing an appropriate balance between fixed and variable remuneration, linked to the achievement of suitably challenging Group and individual performance measures. There is a strong link between the remuneration policy and the business strategy. The Group's strategy focuses on the effective operation of the business necessary to maximise long-term and sustainable RoE and the delivery of superior total shareholder returns on a risk-adjusted basis over the course of the insurance cycle. The Group's remuneration policy and the way it is implemented are closely aligned to this strategy. The Remuneration Committee of the Group's Board of Directors sets the remuneration policy for the Group's Chairman, the Executive Directors, Company Secretary and other designated senior executives to deliver long-term benefits to the Group. LUK has its own Remuneration Committee and wherever possible LUK's remuneration policy will be aligned to the Group's policy.

The remuneration policy is geared towards providing a level of remuneration which attracts, retains and motivates Executive Directors of the highest calibre to further the Group's and subsidiary undertakings interests and to optimise long-term shareholder value creation, within appropriate risk parameters. The remuneration policy also seeks to ensure that Executive Directors are provided with appropriate incentives to drive individual performance and to reward them fairly for their contribution to the successful performance of the Group. The remuneration policy for all staff is, in principle, the same as that for Executive Directors in that any of the Group's employees may be offered similarly structured packages, with participation in annual bonus and long-term incentive plans, although award types (restricted cash or restricted stock) and size may vary between different categories of staff. For Executive Directors with higher remuneration levels, a higher proportion of the compensation package is subject to performance pay, share based remuneration and deferral. This ensures that there is a strong link between remuneration, Group performance and the interests of shareholders.

During 2017 the management team and Board approved a Solvency II remuneration policy which seeks to identify key staff at both Group and subsidiary level so as to ensure appropriate oversight of the remuneration of such individuals, whether by the Group Remuneration Committee level or by the boards and management teams of the relevant subsidiary companies within the Group.

The Non-Executive Directors are paid a single fee for all responsibilities, although supplemental fees may be payable where additional responsibilities are undertaken.

(II) PERFORMANCE CRITERIA

Bonus Plan

The annual bonus is based on financial and personal performance. The precise weightings may differ each year and also differ dependent on the employee's level of seniority and role and responsibilities within the organisation, with more senior employees having a higher weighting to financial performance metrics. Not all roles have a financial performance element to their bonus structure.

The financial component is based on the Group's key financial measures of performance. For any year, these may include RoE, growth in BVS, combined ratio, investment return or any other financial KPI. Typically a sliding scale of targets applies for financial performance targets. Bonus is earned on an incremental basis once a predetermined threshold level is achieved. The degree of stretch in targets may vary each year depending on the business aims and the broader economic or industry environment at the start of the relevant year.

The personal performance component is based upon achievement of clearly articulated objectives. A performance rating is attributed to participating employees, which determines the pay-out for this part of the bonus. The weightings applying to the bonus measures and the degree of stretch in objectives may vary each year depending on the business aims and the broader economic or industry environment at the start of the relevant year.

The Remuneration Committee will have the ability to override the bonus outcome by either increasing or decreasing the amount payable, subject to the bonus cap of 200% of target bonus, to ensure a robust link between reward and performance. At least 25% of bonuses for some Executive Directors' and senior members of management is automatically deferred into shares as nil cost options over three years, with one third vesting each subsequent year. The bonus for some of the Executive Directors is subject to claw back if the financial statements of the Group were materially misstated or an error occurred in assessing the performance conditions on bonuses and/or if the Executive ceased to be a Director or employee due to gross misconduct.

Long Term Incentives

RSS awards are made annually in the form of nil cost options. For some Executive Directors and some members of senior management, vesting is dependent on the achievement of performance conditions over at least three financial years, commencing with the year of grant. For other Executive Directors and all other members of staff, vesting is over three financial years with no performance conditions. The three-year period is longer than the typical pattern of loss reserve development on the Group's insurance business, which is approximately two years. The number of awards will normally be determined by reference to the share price at 1 January in the year of grant unless the Group's Remuneration Committee at its discretion determines otherwise. The Group's Remuneration Committee considers carefully the quantum of awards each year to ensure that they are competitive in light of peer practice and the targets set. Awards are subject to claw back if there is a material misstatement in the Group's financial statements, an error in the calculation of any performance conditions or if the Executive Director ceases to be a Director or employee due to gross misconduct. A dividend equivalent provision operates enabling dividends to be accrued (in cash or shares) on RSS awards up to the point of exercise. Award levels are determined primarily by seniority. A maximum individual grant limit of 350% of salary applies.

Performance metrics awards vest at the end of a three-year performance period based on performance measures reflecting the long-term strategy of the business at the time of grant. These may include measures such as TSR, RoE/BVS, Group profitability or any other relevant financial measures. If more than one measure is used, the Group's Remuneration Committee will review the weightings between the measures chosen and the target ranges prior to each LTI grant to ensure that the overall balance and level of stretch remains appropriate. A sliding scale of targets applies for financial metrics with no more than 25% vesting for threshold performance.

(III) PENSION OR EARLY RETIREMENT SCHEMES

The Company operates a defined contribution pension scheme (via outsourced pension providers) or cash-in-lieu of pension. There is a salary sacrifice structure in the UK and the opportunity for additional voluntary contributions to be made by individuals, if elected. The pension scheme operates on the same basis for all employees in the Group; there are no supplementary retirement schemes for executive directors or key function holders. Non-executive directors do not receive any retirement benefits.

(E) MATERIAL TRANSACTIONS WITH SHAREHOLDERS, PERSONS WHO EXERCISE A SIGNIFICANT INFLUENCE, AND WITH MEMBERS OF THE ADMINISTRATIVE, MANAGEMENT OR SUPERVISORY BODY

Transactions with Members of the AMSB

Remuneration for members of the Company's AMSB is disclosed in note 15 "related party disclosures" to the Company's 31 December 2017 financial statements available on the Group's website: Lancashire Insurance Company (UK) Limited.

B.2 FIT AND PROPER REQUIREMENTS

(A) SKILLS, KNOWLEDGE AND EXPERTISE APPLICABLE TO THE PERSONS WHO EFFECTIVELY RUN THE UNDERTAKING OR HAVE OTHER KEY FUNCTIONS

The Group has implemented a 'fit and proper' policy and process for persons who effectively run the Group and its subsidiary undertakings or hold other key functions. The fit and proper policy explicitly covers the Chairman, CEO, Chairman of the Audit Committee, Chairman of the Remuneration Committee, CFO, CRO, Compliance Oversight Officer and the Heads of Internal Audit and Actuarial functions. The Group defines key functions as those prescribed by the relevant regulators as well as those functions which the Group or subsidiary undertakings considers to be important within the system of governance. Following the implementation of the SIMR in 2016 certain controlled functions were designated SIMR functions, requiring a regulatory pre-approval process to be followed prior to appointment. This requires the firm to provide the PRA with relevant information regarding an individual's skills and experience, roles and responsibilities and fitness and propriety. Each of the areas considered a 'key function' within LUK has a Controlled Function or SIMF owner, as disclosed above.

The fitness for a role is based on the assessment of the individual's management competence as well as their technical competence. The assessment of propriety of an individual is based on their reputation, which will reflect on their past conduct, criminal record, financial record and their supervisory experience.

The following are principal requirements for key function holders:

- Integrity;
- Soundness of judgement;
- Financial soundness; and
- Sufficient knowledge, experience and professional qualifications.

The Group also requires sufficient diversity between key functions holders so that they are able to govern and operate the Group and subsidiary companies effectively. The Group requires that key function holders, as a collective, have sufficient knowledge, experience and qualifications to ensure that they run the Group and subsidiary undertakings professionally and in accordance with the applicable regulations. The collective knowledge and expertise of the individuals holding a key function is such that the Group or subsidiary undertakings can demonstrate:

- There is a professional management team which ensures that the Group and subsidiary companies are run in accordance with all relevant legal and regulatory requirements;
- There is an understanding of the insurance products and processes and the market in which it operates;
- There is an understanding of the finance and actuarial functions including the financing, investments and financial markets, actuarial principles and reinsurance;
- There is an understanding of administrative structures and processes within the organisation including internal controls, information technology and risk management;
- There is an understanding of financial accounting and reporting;
- There is an understanding of any outsourcing arrangements and their proper control; and
- Overall, the collective knowledge should be of an adequate level and consist substantially of individuals each with several years of experience in management of an insurer.

(B) FITNESS AND PROPRIETY OF THE PERSONS WHO EFFECTIVELY RUN THE UNDERTAKING OR HAVE OTHER KEY FUNCTIONS.

A detailed and formal due diligence process takes place if a candidate has been made an offer to join the Company in one of the following roles:

- Senior Management Function;
- 'Significant harm' functions (a person who performs this function will be involved in aspects of the firm's affairs that might involve a risk of significant harm to the firm or any of its customers, including material risk takers) under the certification regime;
- SIMFs;
- FCA Approved Persons Regime (Significant Influence Functions ("SIFs")) insurance controlled functions;
- Notified non-executive directors; and
- Key function holders.

The diligence process includes detailed HR notes from the interview process, a review of the individual's background through the use of an external third party, and regulatory references. The responsibility for completing the due diligence is with the HR Department. The regulatory reference covers the proposed candidate's employment in the preceding six years. This is regardless of whether the past employers are authorised firms or not. A reference is required for internal recruitment of an individual from within the Group when the individual has employment history at other organisations within the previous six years.

Once the due diligence stage has been completed, approval must be sought from the relevant Board.

The fitness and propriety of individuals is an ongoing requirement, therefore the relevant regulator(s) are notified of any changes regarding the individuals who effectively run the Company or are responsible for a key function. If there are changes made to personnel then their fitness and propriety will need to be assessed. If during an assessment of fitness and propriety it is found that an individual no longer fulfils the requirement set out then the relevant regulator(s) will be advised.

The Company has a number of processes in place to ensure ongoing fitness and propriety. All individuals who effectively run the organisation or are key functions holders complete a tailored induction process, aligned to their particular skill set and responsibilities, and, as with all staff, are subject to an annual performance assessment. An ongoing assessment of the Board and its committees is completed annually and includes an overall review of the fitness and propriety of the composition of the Board and committees both collectively and independently .

B.3 RISK MANAGEMENT SYSTEM INCLUDING THE OWN RISK AND SOLVENCY ASSESSMENT

(A) RISK MANAGEMENT SYSTEM

The Lancashire Group's risk management system comprises of its governance structures, risk strategy, policies and procedures, which together encapsulate the way it identifies, analyses, controls, manages and monitors its risk profile and exposures on a continuous basis.

(I) STRATEGIES, PROCESSES AND REPORTING PROCEDURES

Risk Strategy

The primary objective of Lancashire Group and its subsidiary undertakings ERM framework is to ensure that the amount of capital held is consistent with the risk profile of the company and that the balance between risk and reward is considered as part of all key business decisions.

Our overall Group strategic goal remains to maximise risk adjusted return for our shareholders across the longer term. This has been stated as 13% above the risk free rate, noting that it is a cross cycle expectation and we also aim to be profitable 4 years out of 5, targeting a maximum modelled exposure of 25% of our capital to a peak zone loss, be this to a 1 in 100 wind event or a 1 in 250 quake event. In order to achieve these objectives, the Group employs an effective risk management framework. All of the Group's strategic ERM objectives have a common aim of supporting its business and capital strategy. Within this context, the primary strategic ERM objectives are to:

- Ensure that all key decisions and risk taking will be undertaken within boundaries that are defined clearly and aligned to the strategic objectives and risk profile of the Group; and
- Promote informed risk taking that considers the risk reward equation in all major decisions with a view to optimising risk adjusted ROE.

Other key objectives are to:

- Encourage a culture of risk challenge, questioning and understanding including the use of stress, reverse stress and scenario testing to verify assumptions and loss scenarios;
- Quantify and assign risk values to the key risks (within each risk category) to which it is exposed and maintain a risk register to track and manage such risks; and
- Ensure that the Group's and subsidiary undertakings capital resources are aligned with risk levels and comply with relevant regulatory capital requirements.

Risk Appetite
The Group Board and sub-committees set the annual rolling 3 year strategy, from which the risk appetite and risk profile are determined. The risk appetites correspond to the level of exposure the Group and its subsidiary undertakings are willing to accept within each risk category. These risk appetites are expressed through detailed risk tolerances at both a group and subsidiary undertaking level. Risk tolerances represent the maximum amount of capital, generally on a modelled basis, that the Group and its subsidiary undertakings are prepared to expose to certain risks.

All risk appetites and tolerances are subject to at least an annual review and consideration by the respective Boards of Directors. The LHL and individual Boards of Directors review actual risk levels versus tolerances, emerging risks and any risk learning events at least quarterly. In addition, on at least a monthly basis, management reviews the outputs from BLAST in order to assess modelled potential losses against risk tolerances and ensure that risk levels are managed in accordance with them.

Risk Universe
The risk universe is the starting point for the identification and categorisation of all risk exposures within the Group and subsidiary undertakings. The Group's risk universe articulates the range of risks to which it could potentially be exposed, setting the context for the risk management policy framework and the monitoring, quantification and management of risk.

The universe categorises risks into three broad classes: intrinsic risk, operational risk and other risk. These risks for the Group and Company are described in more detail on pages 33 to 35 of the Group's 2017 Annual Report and Accounts, available on the Group's website: Investors – Lancashire Group.

The categorisation in the risk universe is supported by a more granular risk taxonomy demonstrating the linkage between the risk universe, the BLAST capital model, the detailed Risk Register and key monitoring and reporting processes. The risk universe and taxonomy are key to enabling the risk profile across different subsidiary undertakings to be aggregated and reported coherently both internally and externally.

Risk Policy Framework
The Group's risk policy framework formalises its approach to the management of its more material risk categories in a way that can easily be communicated to both internal and external stakeholders.

The policies build upon the high level detail in the risk universe and the detailed controls documented in the risk register. For each category, the policies set out the key underlying sources of risk, the processes in place across the first and second line of defence to prevent and/or detect the risk and the approach to risk transfer or mitigation.

The framework documentation is designed to be proportionate to the scale and complexity of the Group's business and organisational structure and is published on the Group's Sharepoint platform.

ERM Processes and Reporting Procedures:
The ERM processes are effected by the Group and subsidiary undertakings Boards of Directors, management and other personnel, applied in strategy setting and across the Group. They are designed to identify potential events that may affect the Group and subsidiary undertakings, and manage risks within their risk appetite, to provide reasonable assurance regarding the achievement of the Group's objectives. The processes are centred on the Group's risk policies and integrated in the ERM and ORSA procedure documents which explain the day-to-day activities employed in the Group to manage risks. The Group's overall system of risk governance relies on a number of key committees and management processes to bring together effective reports on the management of risk for each management team and board within the Group.

The following annual, quarterly and management processes are in place:

Annual Processes
Group Strategy – The annual strategy is approved by the Group Board of Directors and encompasses a three year forward view, updated and refreshed each year initially at the Group level in the context of the anticipated competitive environment and other considerations. The strategic plan is implemented formally through business plans at the Group and subsidiary undertaking levels which explicitly refer to it, and informally through regular interactions of management. Specific subsidiary undertaking strategic plans are prepared, which closely mirror Group strategy but reflect the specific local strategic drivers.

Business Planning Process – The Group business plan approved by the Group Board of Directors is underpinned by specific subsidiary undertaking plans and projections to allow appropriate consideration and approval by the subsidiary undertaking boards. The plan establishes the risk return objectives, risk and capital appetite and capital management plan for the coming year, considering a range of potential business scenarios supported by the use of stress testing to test forecast financial stability and capital adequacy and inform capital and liquidity management strategies and associated contingency plans.

The process involves extensive input from the underwriting, finance, risk management and actuarial functions with the review of the capital requirements and the risk profile of the proposed plan being undertaken by the RRC supported by the use of the BLAST capital model.

Regulatory Capital Submissions – The process is initiated by the regulatory reporting and finance teams in line with regulatory requirements as applying to the Group and subsidiary undertakings.

Standard Formula Assessment – A Standard Formula SCR is calculated annually for the Company (and more frequently in the event of a material change in the business's risk profile) in accordance with regulatory reporting requirements. To coincide with this, an assessment of the appropriateness of the standard formula for the Company's risk profile is conducted. This assessment considers the significance with which the Company's risk profile deviates from the assumptions underlying the Standard Formula calculation. The reporting of the results includes sufficient detail to demonstrate to the Board the key processes applied and any material assumptions and or limitations of the approach.

Actuarial Function Holder Report – The Actuarial Function produces an annual report for management and the LUK Board formally documenting its tasks conducted and results and conclusions thereon. The report clearly identifies any deficiencies and makes recommendations for improvement where necessary.

The report comprises the following sections:

- Technical provisions review: based on the year-end valuation and validation exercise, covering the appropriateness of the methodologies, data, benchmarks and models plus an analysis of the technical provisions over time and explanation of changes;
- Underwriting policy opinion: to determine whether the current business plan is consistent with the risk appetite of the business; the sufficiency of premiums to cover future expected claims and expenses; the variability around the expected business plan outcome and consideration of underwriting risks;
- Reinsurance adequacy opinion: to determine the appropriateness of the reinsurance structure considering the Group's risk profile, risk appetite and reinsurance policy; the appropriateness of reinsurance providers and their credit standing considering the Group's risk profile and reinsurance policy; the sufficiency of coverage under stressed conditions and consideration of alternatives where deficiencies or shortcomings are found; and
- Contribution to risk management: discussion of the Company's risk assessment, modelling and quantification; determination of the Company's economic capital requirements; the determination of regulatory solvency and minimum capital requirements and review of the ORSA.

Annual Group ORSA Process and Report – On an annual basis the CRO performs an assessment of the Group's and LUK's overall solvency needs and produces a report detailing their risk profiles and the capital and other means needed to address these risks (the ORSA report). In addition the ORSA provides a forward looking analysis of risk and the associated capital requirement. Stress and scenario tests are performed on both the SCR and business plan and the results included within the ORSA. The ORSA is reviewed, challenged and approved by the LHL and LUK Board at the quarter one board meetings.

Quarterly Processes

Quarterly ORSA report – A quarterly ORSA report is prepared for the LUK Board of Directors by the CRO. This draws upon the bi-weekly RRC reviews and supporting BLAST and exposure modelling updates and covers the following:

- Capital resource adequacy;
- Risk levels versus risk tolerances;
- Summary of risk groups and their impact upon capital requirements;
- Volatility and overall risk levels compared to strategy;
- Risk register updates;
- Rating agency update (applicable for the Group only); and
- Emerging risk issues.

The quarterly ORSA is reviewed and challenged, as appropriate, by the LUK Board but not formally approved by it as there are no decisions to be taken in the paper.

Group CFO Capital Management Review – A quarterly capital management paper is prepared for the Group Board of Directors by the Group CFO who reports its conclusion and recommendations to the Board. It draws upon the rating agency and capital management procedure and on-going regulatory capital monitoring process and covers the following:

- Capital position, review and projections;
- Capital management recommendations;
- Analysis of capital measures;
- Analysis of capital tolerances;
- Rating agency and shareholder views;
- Projections and impact on RoE; and
- Headroom strategy.

Group Board Underwriting & Underwriting Risk Committee Review – The Underwriting and Underwriting Risk Committee considers insurance risk levels and strategy in detail on a quarterly basis. The committee:

- Formulates the Group underwriting strategy;
- Oversees the development of and adherence to underwriting guidelines by operating company CUOs;
- Reviews underwriting performance and significant changes in underwriting rules and policy;
- Establishes, reviews and maintains strict underwriting criteria and limits; and
- Monitors underwriting risk and its consistency with Lancashire's risk profile and risk appetite.

Group Board Investment Committee Review – The Investment Committee reviews the investment portfolio and risk levels in detail on a quarterly basis. The committee:

- Recommends investment strategies, guidelines and policies for the Board of the Company and other members of the Group to approve annually;
- Recommends and sets risk asset definitions and risk tolerance levels;
- Recommends to the relevant Boards the appointment of investment managers to manage the Group's investments;
- Monitors the performance of investment strategies within the risk framework; and
- Establishes and monitors compliance with investment operating guidelines relating to the custody of investments and the related internal controls.

Management Committee Reviews

RRC Review – The RRC is a Group committee and includes the Group CEO and members from the finance team, actuarial and underwriting functions. The Group CRO attends the meetings and reports on the RRC's activities to the Group and subsidiary undertaking Boards of Directors. The RRC meets on approximately a bi-weekly basis covering a range of ORSA related topics set out in their terms of reference and annual timetable, both of which are reviewed on an annual basis to ensure that they best meet the Group's and subsidiary undertakings needs in a changing internal and external environment.

Each meeting of the RRC considers the core insurance risk profile against Group and subsidiary undertaking risk appetites, supported by bi-weekly elemental PML modelling and monthly non-elemental RDS analysis. The RRC has a key role in terms of oversight of the BLAST capital model, evaluating the appropriateness of and any proposed major changes to its design, implementation and operation and ensuring that it remains an effective tool to support decision making.

IRRC Review – The Group committee meets once each quarter to ensure that the Group's strategies and tactical investment actions are consistent with our investment risk preference, appetite and risk and return objectives. The committee also reviews new products and potential correlations with insurance risk. The committee further ensures the risk tolerances are incorporated into the overall risk appetite framework.

On a quarterly basis, the committee's reports and conclusions are reviewed by the RRC.

Reserve Committee review – The committee meets formally at least quarterly to review and approve all significant ($5,000,000 plus) individual claim reserves and any additional case reserves of $500,000 or over. Although a single meeting is held the committee consists of LUK members and LICL members who can only make decisions in respect of their own companies.

Group Reinsurance Security Committee review – The committee is responsible for the monitoring and approving of individual reinsurers and intermediary counterparties within the framework of overall limits and methodologies maintained by the RRC. Whilst the committee meets formally on a quarterly basis approvals may be made more frequently via email as business needs require.

On-going Management Processes

Aggregation, Monitoring and Reporting – Underwriting risk is by far the greatest driver of the Group's and LUK's overall risk profile and capital requirements and this is reflected in the scope, granularity and frequency of monitoring of both elemental and non-elemental catastrophe risk exposures.

Elemental exposures are considered on the basis of PML at a range of return periods, whereas, non-elemental exposures are considered in terms of deterministic RDS representing hypothetical extreme, but nonetheless credible, potential loss scenarios.

The RRC reviews the PMLs and RDSs on at least a monthly basis and in addition they are reported to the Group and LUK Boards through the quarterly CRO reporting. Any projected or actual breach of limits requires immediate action by management, the risk owner being required to immediately contact the CRO with an explanation and mitigating plan.

Actual breaches require a mitigating plan approved by the CRO and the CEO and are reported to Group management, the RRC and appropriate Board(s).

Group Rating Agency and Capital Management – The significance of this area is such that it is covered by a specific rating agency policy, associated procedure and supporting processes forming part of the overall system of governance. These processes explain how the Group monitors available capital headroom given the current book of business, the projected book of business and various stress tests scenarios.

Regulatory Capital Monitoring – The Company is subject to regulatory requirements in respect of Solvency II regulation of LUK. The Company maintains and operates a series of processes to ensure and evidence continued compliance with their regulatory requirements and resultant changes in regulatory and supervisory arrangements.

Operational Risk Management – Risk Registers encompassing assessments of all material operational risks and the controls designed to prevent, mitigate or detect them at both Group and subsidiary undertaking levels are maintained.

On a quarterly basis, individual risk owners are required to formally reassess and reaffirm the full scope of their controls and semi-annually the gross and net risk scores for which they are responsible are reassessed. The self-assessment is recorded on the Lancashire Governance Portal and is subject to CRO review, challenge and approval. In the intervening quarters the CRO meets with all risk owners to have a detailed discussion on their risks and reaffirm the gross and net risk scores. As part of this process, management's desired audit ratings for control effectiveness are reassessed in light of the risk assessment and control criticality and recorded by the Internal Audit function to be taken into audit planning and review process.

A qualitative assessment of key risks and any material changes is reported quarterly by the CRO to Board(s) supported by an extract from the register showing key risks and their scores.

Solvency II Technical Provisions Monitoring – The technical provisions for the Company are calculated by the Reporting Actuary (a member of the actuarial function) on a quarterly basis and reported to the PRA quarterly following review by the regulatory reporting team and the LUK Finance Director. On an on-going basis, the actuarial function is responsible for ensuring continuous compliance with Solvency II requirements regarding the calculation and validation of Solvency II technical provisions and identifying potential risks arising from the uncertainties connected to this calculation.

Emerging Risk Management – The Group identifies and monitors emerging risks through a range of channels including but not limited to semi-annual CRO reviews with risk owners, CRO attendance at key committees, a rolling review as part of the RRC annual timetable and the review of external inputs.

An emerging risk register is maintained by the CRO and emerging risks are a standing item in the CRO's quarterly ORSA report to the Board(s) ensuring that they remain under consideration at Board level.

Stress and Scenario Testing – The Group conducts sensitivity, stress (standard and reverse) and scenario testing on both a scheduled and ad-hoc basis at the Group and LUK level as part of a number of the underlying components in the ERM and ORSA framework.

(II) ORGANISATIONAL STRUCTURE AND DECISION-MAKING PROCESSES

The governance and the implementation of an effective risk management system within the Lancashire Group is facilitated by the Group Risk Management function whose role it is to deliver ERM across all aspects of the Group and its subsidiary undertakings. The function is headed up by the CRO who reports directly to the Chairmen of the Group and subsidiary undertaking Boards and facilitates and aids the identification, evaluation, quantification, mitigation and control of risks at a Group and subsidiary undertaking level with support from the Risk Management and Actuarial functions. Facilitating and embedding of ERM and helping the Group improve its ERM practices is a major responsibility assigned to the CRO who drives the risk assessment process including maintaining the Group's risk register and ensuring the efficacy and appropriateness of the risk management procedures and processes.

The CRO provides regular reports to the Group and subsidiary undertaking Boards covering, amongst other things, actual risk levels against tolerances, emerging risks and any lessons learned from risk events. The Group Board considers that a supportive ERM culture, established at the Board and embedded throughout the subsidiary undertakings, is of key importance.

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 aligned with the business cycle.

Chief Risk Officer

The primary role of the Group CRO is to facilitate the effective operation of ERM and the ORSA process throughout the Group at all levels. The role includes but is not limited to the following responsibilities:

- Overall management of the risk management system;
- To drive ERM culture, ownership and execution on three levels: Board, executive management, and operationally within the business;
- To facilitate the identification, assessment and evaluation of existing and emerging risks by management and the Boards, including the articulation of management's risk preferences and the adoption of formal Board approved risk tolerances;
- To ensure that these risks are given due consideration and are embedded within management's and the Boards oversight and decision making process;
- To be consulted, and opine on, policy in areas such as, but not limited to, underwriting, claims, investments, operations and capital management; and
- To provide timely accurate, reliable, factual, objective and accessible information and analysis to guide, coach and support decision making.

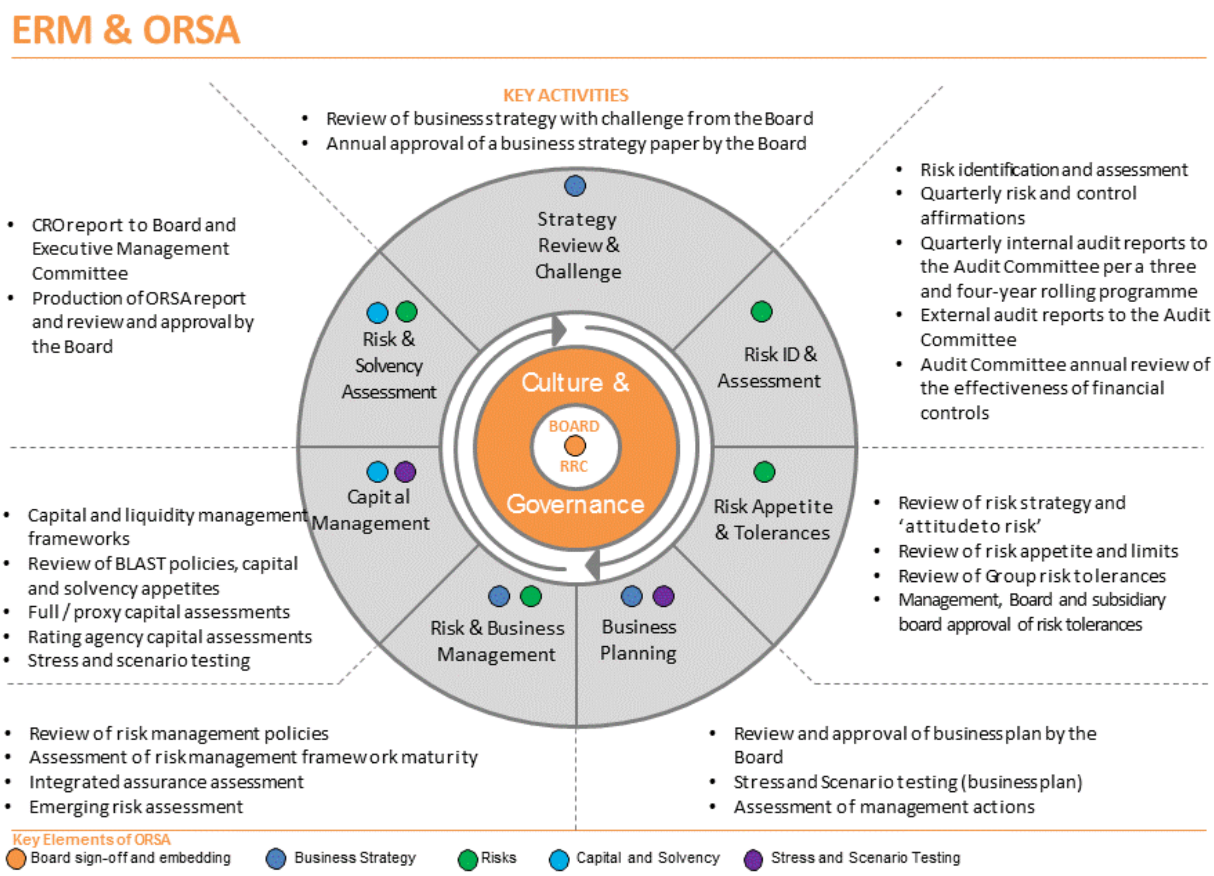
Responsibility for the management of individual risks has been assigned to, and may form part of the performance objectives of the risk owner within the business. Risk owners ensure that these risks and controls are consistent with their day to day processes and the entries made in the risk registers, which are a direct input into the capital model. The CRO provides regular reports to the business outlining the status of the Group's ERM activities and strategy, as well as formal reports to the Board of Directors of the Group and the boards of LUK and LICL. The Group CRO ultimately has the right to report directly to the Group and subsidiary undertaking regulators if she feels that management is not appropriately addressing areas of concern.

(B) ORSA

(I) ORSA PROCESS

The ORSA process is integrated into the overall ERM framework, and is embedded in the entirety of the Group's risk management processes and procedures outlined above, which seek to identify, assess, manage, monitor and report the risk exposures of the business and its strategy. It also encompasses activities used to determine the adequacy of Own Funds necessary to ensure that the overall solvency needs of the Group and LUK are met at all times and involves a continuous current year risk profile monitoring and reporting as well as forward looking forecasting of risk profile.

The diagram below illustrates how the various parts of the ERM framework come together to form our ORSA process.



ORSA Supervisory Report

The ORSA report is a material output of the ongoing ORSA and ERM processes. It reports on the dynamic elements of the ORSA process, focussing on the moving components of the Group's and subsidiary undertakings solvency and risk profile to enable management to make informed decisions. The Group has received confirmation from the PRA that it should submit a single Group ORSA, covering both the Group and LUK rather than one each for the Group and LUK, for the annual periods 2016 to 2019.

In summary, current year monitoring processes feed into the CRO's quarterly ORSA report to the boards; whilst the forward looking forecasting process feeds into the annual ORSA report. In both instances the reports are used to support decision making and are standing agenda items for the Boards and other committees.

A full ORSA report would also be produced on an ad-hoc basis as required following the performance of an out of cycle ORSA resulting from a planned or unplanned material change in the risk or solvency profile of the business. The Group will report the results of the Group ORSA process to its supervisor. In an out of cycle ORSA, the decision to conduct such an ORSA will be notified to the supervisor in a timely fashion upon the occurrence of the trigger event and a date agreed for reporting. Trigger events will include, but not necessarily be limited to, planned or unplanned risk or solvency profile changes such that:

- The Group or LUK breaches or would expect to breach its capital and solvency tolerances; and
- The risk profile of the business changes or is expected to change in such a way that the methodologies used to calculate its capital requirements are no longer deemed reliable for the projected risk profile.

In the event of an out of cycle ORSA, the results will be reported to the supervisor without undue delay following review and approval by the appropriate Board(s) and in conjunction with the compliance function.

(II) ORSA: BOARD REVIEW AND APPROVAL

On an ongoing basis, the Boards review the Group and LUK risk profile via the quarterly ORSA report produced by the CRO for the Group and subsidiary undertaking boards. The quarterly ORSA report covers all material risk exposures within each category of risk as well as comment on the Group and LUK solvency capital profile. The annual ORSA report is reviewed and approved by the Group Board and the LUK Board prior to regulatory submission.

(III) SOLVENCY NEEDS AND RISK PROFILE

As part of the Group's ongoing ORSA process, it models the internal view of its risk profile and the capital requirements within its internal economic capital model BLAST. The BLAST model reflects the Group's aggregate risk profile and models all of its major risk categories. It combines the LICL, LUK and KCM risk profile, and the outputs from the Internal Models in place for the two CUL syndicates, independently to understand the contribution of each risk category to the overall capital and solvency profile of the Group.

The Group considers a wide range of measures when establishing the appropriate level of capital at Group and subsidiary undertaking level including its internal measures of capital requirements, used for reviewing risk and solvency profile across subsidiary undertakings, applicable regulatory minima (i.e. BMA and PRA SCR) and external rating agency capital requirements.

Risk tolerances are set at a level that aims to prevent the Group and subsidiary undertakings incurring losses that would impair their ability to operate. The Group's key capital measure is currently its A.M. Best rating. Our maintenance of a Group AM Best rating of a minimum of A- or higher remains the key determinant of our ability to attract and retain business in the markets in which we operate. In 2017, the Group maintained its A rating.

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 plus 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 undertakings also conduct capital requirement assessments under internal measures and in compliance with local regulatory requirements.

B.4 INTERNAL CONTROL SYSTEM

(A) INTERNAL CONTROL SYSTEM

The LHL Board has overall responsibility for ensuring that an adequate and effective system of internal control is established and maintained throughout the Group, including the main subsidiary undertakings. The Subsidiary undertaking Boards are responsible for approving and periodically reviewing the overall business strategies and significant policies as well as the organisational structure and internal control strategy of the respective companies. The Boards provide direction, guidance and suitable prudential oversight, ensuring that the companies are appropriately and effectively managed, controlled and in compliance with laws and regulations. The Boards are supported in discharging those responsibilities by the company secretarial function and with advice and guidance from the legal and compliance function. The Boards are responsible for the supervision and evaluation of the respective company's performance, including management.

Internal control can be defined as a continuous set of processes carried out by the Boards of Directors of the subsidiary undertakings, management and all personnel, designed to provide reasonable assurance of:

- effectiveness and efficiency of operations;
- reliability of financial and non-financial information;
- adequate control of risks;
- prudent approach to business; and
- compliance with laws and regulation, and internal policies and procedures.

The key components of the Group's internal control system are:

- the affirmation process;
- the internal audit function; and
- the Board and its committees (both on a Group and subsidiary undertaking level).

Lancashire maintains an effective internal control system comprising efficient control activities applied across all key areas of business operations.

The key control activities within the Group and its subsidiary undertakings include:

- approval processes;
- authorisations;
- verifications;
- reconciliations;
- management reviews;
- appropriate measurements applicable to each business area;
- monitoring compliance with agreed exposure limits and operating principles/instructions, and
- follow-up on non-compliance.

The control activities are proportionate to the risks coming from the processes and they ensure that any potential conflicts of interest are identified and managed appropriately.

Control Monitoring

Through its monitoring of the control framework the Group seeks to have a continual cycle of review and improvement to ensure that the control framework remains appropriate to the needs of the Group and subsidiary undertakings and provides management with assurance of the effectiveness of the controls framework and that procedures are in place to detect deficiencies.

Each control is allocated to an individual control owner. The risk register identifies the named control owners who are responsible for the effective performance of each of the identified controls. The actual operation of the control can be delegated by the control owner to a control operator, notwithstanding the control owner remains responsible for the suitability and operation of the control.

On a quarterly basis all control owners/operators affirm the effectiveness and appropriateness of their assigned controls within the Lancashire Governance Portal in a process that is facilitated by the Group risk management function and the CRO. All control assessments are then reviewed and approved by the CRO who reports any material changes to the Board on a quarterly basis.

(B) COMPLIANCE FUNCTION

The Group is committed to ensuring compliance with all applicable laws and regulations and has no tolerance for breaches or a failure to adhere to prudential regulatory standards as well as the standards of conduct expected of it in those markets and territories in which it operates.

The Group and Company has implemented policies and procedures to document the control environment in place including how it mitigates regulatory risk. The Group recognises that compliance is the responsibility of all staff and directors, including non-executive directors. Ensuring the implementation of a compliance policy throughout the firm is the responsibility of the Group and subsidiary undertaking boards. On a day-to-day basis executive management and SIMFs/Approved Persons who act in an executive capacity are responsible for ensuring that the policy remains appropriate and effective.

All members of the compliance function have the appropriate experience and expertise relevant to their individual roles, providing a mix and balance of skills, so that they collectively can fulfill their duties.

The Group's compliance function identifies, assesses, monitors and reports on ongoing compliance risk exposure, including the tracking of changes in the environment that could affect the compliance and regulatory risk and the monitoring of the appropriateness of the Group's and LUK's compliance.

B.5 INTERNAL AUDIT FUNCTION

(A) INTERNAL AUDIT FUNCTION

The Head of Internal Audit oversees internal audit and assists executive management and the Audit Committee of the Board of Directors in discharging their responsibilities by furnishing them with analyses, advice and recommendations concerning activities reviewed and by promoting effective and efficient controls and pursuing corrective action on significant issues.

Annually, Internal Audit submits to the Audit Committee a detailed audit plan outlining the proposed audit methodology, work schedule and budget for the following fiscal year. The audit work schedule is developed based on a prioritisation of the audit universe using a risk-based methodology. Any significant deviation from the formally approved work schedule is communicated to senior management and the Audit Committee through periodic activity reports.

A written report is prepared and issued by Internal Audit following the conclusion of each audit and is distributed as appropriate. A summary audit report is provided to the Audit Committee. The audit reports include the auditee's agreed actions to be taken in respect of each specific finding. Reports must outline clearly any instances where Internal Audit and the auditee are unable to formulate satisfactory agreed actions and the Audit Committee will then determine the appropriate actions.

Management's response should include a timetable for anticipated completion of action to be taken and an explanation for any recommendations not addressed.

Management will be responsible for appropriate follow-up on those audit findings and recommendations. All significant findings will remain open in Internal Audit's issue tracking software until cleared by Internal Audit or the Audit Committee.

(B) INTERNAL AUDIT FUNCTION: INDEPENDENCE AND OBJECTIVITY

Internal Audit's roles and responsibilities are clearly defined through the Internal Audit Charter, available on the Group's website here: Board Committees – Lancashire Group. This states that all internal audit activities shall remain free of influence by any element in the organisation, including matters of audit selection, scope, procedures, frequency, timing, or report content to permit maintenance of an independent and objective mental attitude necessary in rendering reports.

The Internal Audit function maintains its independence and objectivity from the activities it reviews by the Head of Internal Audit reporting directly to the Audit Committee. In addition, the CRO has input to the scope of each audit and receives a copy of each internal audit report. This integration of internal audit and ERM into the business helps facilitate the Group's protection of its assets and reputation and maintain Internal Audit's objectivity.

The Internal Audit team govern themselves by adherence to The Institute of Internal Auditors' (IIA) International Professional Practice Framework ('IPPF').

B.6 ACTUARIAL FUNCTION

The actuarial function consists of individuals with the appropriate skillsets and knowledge of financial and insurance mathematics commensurate with the nature, scale and complexity of the Group's business and meets the requirements and tasks of Article 48 of the Solvency II Directive. All members of the actuarial function are either fully qualified actuaries or working towards qualification. As such, experience and skills are maintained through continued professional development/education and adherence to the relevant professional body's code of conduct, standards or practice.

Consistent with the scale and complexity of the Group's business, Lancashire's actuarial function is relatively small. In order to demonstrate independence between performing and reviewing work Lancashire engaged external actuaries during the year to:

- Conduct independent reviews of the Group's claims reserves on an IFRS basis on a six monthly basis; and
- Perform validation of the basis and methodology underlying the Solvency II [Economic Balance Sheet ('EBS')] technical provisions.

B.7 OUTSOURCING

The key objectives of the Group's outsourcing policy are:

- To ensure that the Group and subsidiary undertakings receive optimal value for money whilst also understanding and controlling the risks involved in the engagement of third party providers or outsourcing services; and
- to ensure compliance with the relevant regulatory requirements in which the Group's subsidiary undertakings operate in respect of any outsourcing undertaken. In particular to remain in compliance with Article 49 of the Solvency II Directive, which states that; "a firm cannot outsource a critical or important operational function or activity in such a way as to lead to:
  - Materially impairing the quality of the firm's system of governance;
  - Unduly increasing the operational risk;
  - Impairing the ability of the supervisory authorities to monitor the firm's compliance with its obligations; and
  - Undermining continuous and satisfactory service to policyholders".

LUK remains fully responsible for discharging all of its obligations under the rules and other laws, regulations and administrative provisions, and therefore cannot contract out its regulatory obligations and takes care to supervise the discharge of any outsourced functions and/or activities. None of the Group's or Company's key or important functions are outsourced; however external service providers are used in certain instances to provide expertise, skills or products that are not available internally. In all instances key and important functions are managed and supervised by Lancashire employees, who retain oversight and responsibility for the functions.

Areas in which external service providers are utilised by the Group's key and/or important functions are as follows:

Internal Audit

The Group's Internal Audit function uses various "co-source" service providers to provide assistance with audits that are particularly technical or specialist in nature, for example IT, actuarial or tax related matters. In all instances the co-source audit provision is managed by the Head of Internal Audit and the results of the audits are reported to management and the Group and Company Audit Committee using reporting and scoring consistent with the internally sourced internal audits.

Actuarial Function

As noted in Section B.6 above, during 2017 the Group's actuarial function has used external actuaries, based in the UK, to provide independent support around aspects of the IFRS and Solvency II technical provision processes. The independent actuary also acts as "Approved Actuary" for the Company and provides the required regulatory opinion on the Company's reserves. This support is not considered to constitute outsourcing of the role or tasks of the Actuarial Function; the responsibility for these is maintained internally.

Finance and Investment Management

The Group's Board and management recognise that the Group's principal expertise lies in underwriting so we use the services of internationally recognised investment managers, custodians and investment accountants who are experts in their respective fields to provide assistance with the day-to-day management of the Group's and subsidiary undertakings investment portfolios and accounting and risk reporting thereof. The use of such services also provides the Group with access to extensive and high quality research into investments and capital markets that would be inefficient to derive internally. The responsibility for managing the outsourcing of the relationship with these third party service providers lies with the Group Head of Investments and Treasury.

Investment guidelines are established by the Investment Committee of the Group's Board of Directors; LUK's guidelines are aligned to those of the Group and determine parameters within which the Group's investment managers must operate. Compliance with the investment guidelines is monitored by the internal investment management team on a monthly basis. Further details regarding the Company's investment guidelines are available in the Investment Risk section of the Company's financial statements, from page 26 of the financial statements for 31 December 2017 available on the Group's website: Lancashire Insurance Company (UK) Limited.

The Company has entered into an outsourcing arrangement to support it in the processing and matching of some of its technical cash items and the processing of related endorsements and declarations. The Company holds weekly review meetings with the provider and monthly strategy meetings, with a member of the Company's senior management in attendance, and furthermore receives regular detailed reports on progress.

IT

The IT function uses service providers to provide business continuity services off site . Third parties, based in the UK, are also used to provide data back-up services and email scanning and archiving services. The use of external providers for such services is considered best practice for IT continuity risk management.

B.8 ANY OTHER INFORMATION

All material information regarding the Company's system of governance has been described in sections B1-B7 above. The Company considers its system of governance to be appropriate given the nature, scale and complexity of the risks inherent in its business.

The Company is exposed to risks from several sources. These include underwriting risk, market risk, liquidity risk, credit risk, operational risk and strategic risk. The primary risk to the Company is insurance underwriting risk. There have been no material changes to the Company's material risks or the measures used to assess these risks over the 2017 reporting period.

C.1 UNDERWRITING RISK

Underwriting risk continues to dominate the Company's risk profile. It has the highest impact on the regulatory capital requirements of Solvency II SCR as well as being the primary driver for our capital decisions.

The Company underwrites worldwide, predominantly short-tail, insurance and reinsurance contracts that transfer insurance risk, including risks exposed to both natural and man-made catastrophes. The Company's exposure in connection with insurance contracts is, in the event of insured losses, whether premiums will be sufficient to cover the loss payments and expenses.

Some of the Company's business provides coverage for natural catastrophes (e.g. hurricanes, earthquakes, wildfires and floods) and is subject to potential seasonal variation. A proportion of the Company's business is exposed to large catastrophe losses in North America, Europe and Japan as a result of windstorms. The level of windstorm activity, and landfall thereof, during the North American, European and Japanese wind seasons may materially impact the Company's loss experience. The North American and Japanese wind seasons are typically June to November and the European wind season November to March. The Company also bears exposure to large losses arising from other non-seasonal natural catastrophes, such as earthquakes, tsunamis, droughts, floods and tornadoes, from risk losses throughout the year and from war, terrorism and political risk and other events.

The Company's material risk concentration exposure to certain peak zone elemental loses, are shown below. Net loss estimates are before income tax and net of reinstatement premiums and outwards reinsurance.

As at 31 December 2017		100 year return period estimated net loss $'000	250 year return period $'000
Zones	**Perils**		
Gulf of Mexico(1)	Hurricane	13,269	21,381
Non-Gulf of Mexico – U.S.	Hurricane	2,293	2,966
California	Earthquake	2,191	2,667
Japan	Earthquake	1,016	1,096
Pacific North West	Earthquake	1,293	1,968
Japan	Typhoon	88	121
Pan-European	Windstorm	548	891

(1) Landing hurricane from Florida to Texas

The Company considers insurance risk at an individual contract level, at a segmental level, a geographic level and at an aggregate portfolio level. This ensures careful risk selection, limits on concentration and appropriate portfolio diversification are accomplished.

Losses in LUK's classes are hard to predict as to the specifics of timing and quantum of occurrence and they can also exceed expectations in terms of both frequency and severity. So, although the Company models losses, for example using the RMS and AIR stochastic models, it is cognisant that these projections may be wrong in many instances.

Management uses an internal economic capital modelling tool 'BLAST' for monitoring its insurance risks. Within BLAST, insurance risk accounts for the majority of the allocated risk capital, so this is the principal area where the Company stringently applies controls and reviews. For example, a large number of controls are placed around monitoring risk levels across the business with the level of insurance risk tolerance per peril set by the Board of Directors.

The RRC reviews the PML's and RDSs on at least a monthly basis and in addition they are reported to the LUK Board through the quarterly CRO reporting. Any projected or actual breach of limits requires immediate action by management, with the risk owner being required to immediately contact the CRO with an explanation and mitigating plan. Actual breaches require a mitigating plan, which must be approved by the CRO and the CEO and are reported to Group management, the RRC and appropriate Board(s).

Mitigation
A number of controls are deployed to manage the amount of insurance exposure assumed:

- the Group has a rolling three-year strategic plan that helps establish the over-riding business goals that the Board of Directors aims to achieve. LUK aligns its strategic plan to the Group's;
- a detailed business plan is produced annually which includes expected premiums and combined ratios by class and considers risk-adjusted profitability, capital usage and requirements. The plan is approved by the Board of Directors and is monitored, reviewed and updated on an ongoing basis;
- BLAST and SHARP are used to measure occurrence risks, aggregate risks and correlations between classes and other non-insurance risks, and the outputs and assumptions from BLAST and SHARP are reviewed periodically by the RRC;
- each authorised class has a predetermined normal maximum line structure;
- each underwriter has a clearly defined limit of underwriting authority;
- the Group and subsidiary undertakings have predetermined tolerances on probabilistic and deterministic losses of capital for certain single events;
- risk levels versus tolerances are monitored on a regular basis;
- a daily underwriting call is held for LICL and LUK to peer review insurance proposals, opportunities and emerging risks;
- sophisticated pricing and aggregation models are utilised in certain areas of the underwriting process, and are updated frequently;
- BLAST and other modelling tools are deployed to model catastrophes and resultant losses to the portfolio, the Group and the Company; and
- reinsurance may be purchased to mitigate both frequency and severity of losses on a treaty or facultative basis and to improve risk-adjusted RoE as modelled in BLAST.

Monitoring
The continued effectiveness of the risk mitigation techniques is monitored by the LUK Board through their review of the quarterly ORSA report and by management through the bi-weekly RRC meetings. These are described more fully in Section B to this report, above.

Use of Special Purpose Vehicles
Although the majority of the Group's reinsurance arrangements are with highly rated counterparties a small number of special purposes vehicles were utilised for reinsurance protection during 2017. These accounted for 14.1% of the Group's reinsurance cover purchases and relates largely to LICL. The fully funded principle is met as all the reinsurance protections were fully collateralised up to the limit of the relevant contracts. The collateral can only be released post expiry of the contract with Lancashire's agreement. The special purpose vehicles are registered in Bermuda and are not therefore authorised under Article 211 of the Solvency II Directive.

C.2 MARKET RISK
Market risk relates to the uncertainty in the level or volatility of the market prices of financial instruments. Movements in investments resulting from changes in interest and inflation rates and currency exchange rates, amongst other factors, may lead to an adverse impact on the value of the Company's investment portfolio. Investment guidelines are established by the Investment Committee of the Board of Directors to manage this risk. Investment guidelines set parameters within which the Group's and LUK's external investment managers must operate. Important parameters include guidelines on permissible asset classes, duration ranges, credit quality, currency, maturity, sectors, geographical, sovereign and issuer exposures. Compliance with guidelines is monitored on a monthly basis. Any adjustments to the investment guidelines are approved by the Group Investment Committee and the LUK Board of Directors.

Prudent person principle
The Solvency II Directive 2009/138/EC requires companies to invest assets in accordance with the 'prudent person principle'. The broad requirements relevant to the Company are as follows:

- investment should be in assets whose risks can be properly identified, measured, monitored, managed, controlled, reported and taken into account when calculating the solvency capital requirement;
- investment should be carried out in such a way as to ensure the security, quality, liquidity and profitability of the portfolio as a whole;
- assets held to cover technical provisions should match the nature and duration of the insurance and reinsurance liabilities;
- conflicts of interest should be managed to ensure that the investment is made in the best interest of policy holders;
- the use of derivatives should be restricted to reduction of risks or for efficient portfolio management;
- assets not traded in regulated financial markets should be kept to a minimum;
- the portfolio should be diversified in terms of asset class, issuer and geographical location; and
- there should not be excessive risk concentration in relation to an issuer or issuer Group.

The Company typically invests in commonly traded and non-complex products. The Company invests its portfolio in highly rated securities, across a number of sectors and a number of types of fixed maturity securities, and has a high proportion of government backed securities. Strict guidelines govern investment policy and the portfolio is monitored closely in terms of security, quality, liquidity, profitability and duration.

Risk concentration is closely monitored to ensure that there is no excessive concentration with one issuer or issuer Group although there is a degree of concentration with the U.S. government and agencies. Concentration risk is an immaterial component of ($47,000) of our SCR charge.

Assets are held to match the duration of liabilities as far as possible. Given that the majority of liabilities are denominated in U.S. dollars there is naturally significant amount of U.S. denominated assets.

Performance and accounting reports are received for all investments and a summary report is prepared for management, the Investment Committee and the Board.

Detailed risk disclosures covering the Company's investment portfolio are included in the LUK financial statements for 31 December 2017, pages 26-29 available on the Group's website: Lancashire Insurance Company (UK) Limited.

Mitigation
Our investment risk is mitigated through the following:

- 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 Risk and Return Committee: the IRRC forms an integral part of our risk management framework, meeting at least quarterly and reporting to the RRC quarterly;
- Diversification: our portfolio is diversified across a number of sectors, geographical areas and types of investment; and
- External advisers: The Board and management recognise that the Company's principal expertise lies in underwriting so we use the services of internationally recognised investment managers who are experts in their fields.

Monitoring
The continued effectiveness of the risk mitigation techniques is monitored by the LUK Board through their review of the quarterly ORSA report and the quarterly management IRRC meetings. These are described more fully in Section B to this report, above.

CURRENCY RISK

The Company is exposed to currency risk to the extent its assets are denominated in different currencies to its liabilities. The Company is also exposed to non-retranslation risk on non-monetary assets such as unearned premiums and deferred acquisition costs. Exchange gains and losses can impact profit or loss.

Although the Group considers that the currency risk exposure is not sufficiently material to impact upon the resilience of its balance sheet either at a Group or subsidiary undertaking level, its impact is limited to its effects on mean returns and the volatility of the same. It hedges monetary non-U.S. dollar liabilities primarily with non-U.S. dollar assets, but may also use derivatives to mitigate foreign currency exposures. The Company's main foreign currency exposure relates to its insurance obligations, cash holdings, investments and premiums receivable.

Mitigation
The Company buys and sells currency for the purposes of managing currency exposures and monitors its currency risk exposure against set tolerances.

Monitoring
The continued effectiveness of the risk mitigation techniques is monitored by the LUK Board through their review of the quarterly ORSA report and the quarterly management IRRC meetings. These are described more fully in Section B to this report, above.

C.3 CREDIT RISK

Credit risk is the risk that a counterparty may fail to pay, or repay, a debt or obligation. The Company is exposed to credit risk on its fixed maturity investment portfolio and its inwards premiums receivable from brokers, insureds and cedants, with our largest credit risk exposures coming from our reinsurance counterparties on the amounts recoverable from reinsurers.

The table below presents an analysis of the Company's major exposures to counterparty credit risk, based on their rating. The table includes amounts due from policyholders and unsettled investment trades. The quality of these receivables is not graded but, based on management's historical experience, there is limited default risk associated with these amounts.

As at 31 December 2017	Financial assets $'000	Receivables and other assets $'000	Reinsurance recoverables $'000
AAA	69,937	–	–
AA+, AA, AA-	14,868	–	–
A+, A, A-	31,465	10,855	268,082
BBB+, BBB, BBB-	27,899	–	–
Other	8,564	21,716	–
Total	**152,733**	**32,571**	**268,082**

Reinsurance Counterparty

The Group makes extensive use of both external and intra-group reinsurance as part of its overall risk return optimisation approach and accepts a degree of trade-off between mitigating underwriting risk and incurring counterparty risk. Overall, the Group and its subsidiary undertakings have low exposure to credit risk as the majority of the large outwards reinsurance contracts are placed with highly rated reinsurers or are collateralised. The LHL Board of Directors has approved Group tolerance limits within which LUK operates and management has set preferences for exposures to a single external counterparty in respect of non-proportional reinsurance. All limits are monitored at the Group and subsidiary undertaking level on a regular basis.

Counterparty credit risk from reinsurers is not a material component of our SCR charge at $2,200,000.

Mitigation

Credit risk on the fixed maturity portfolio is mitigated through the Company's policy to invest in instruments of high credit quality issuers and to limit the amount of credit exposure with respect to particular ratings categories and any one issuer. Securities rated below an S&P or equivalent rating of BBB-/Baa3 may comprise no more than 10.0% of portfolio value, with the exception of U.S. government and agency securities. The Company is therefore not exposed to any significant credit concentration risk on its investment portfolio, except for fixed maturity securities issued by the U.S. government and government agencies

Credit risk on inwards premiums receivable from insureds and cedants is managed by conducting business with reputable broking organisations, with whom the Company has established relationships, and by rigorous cash collection procedures. The Company also has a broker approval process in place. Binding authorities are subject to standard market controls including credit control. Reinsurance credit risk is primarily managed by the review and approval of all reinsurers by the Reinsurance Security Committee.

Monitoring

The continued effectiveness of the risk mitigation techniques is monitored by the LUK Board through their review of the quarterly ORSA report and the quarterly management IRRC meetings for credit risk in the investment portfolio and the Reinsurance Security Committee for credit risk relating to the reinsurance recoverables. These are described more fully in Section B to this report, above.

C.4 LIQUIDITY RISK

Liquidity risk is the risk that cash may not be available to pay obligations when they are due without incurring an unreasonable cost.

The Company's main exposures to liquidity risk are with respect to its insurance and investment activities. The Company is exposed if proceeds from financial assets are not sufficient to fund obligations arising from its insurance contracts. The Company can be exposed to daily calls on its available investment assets, principally to settle insurance claims.

Exposures in relation to insurance activities are as follows:

- Large catastrophic events, or multiple medium-sized events in quick succession, resulting in a requirement to pay a large value of claims within a relatively short time frame or fund trust accounts;
- Failure of insureds or cedants to meet their contractual obligations with respect to the payment of premiums in a timely manner; and
- Failure of reinsurers to meet their contractual obligations with respect to the payment of claims in a timely manner.

Exposures in relation to investment activities are as follows:

- Adverse market movements and/or a duration mismatch to obligations, resulting in investments being disposed of at a significant realised loss; and
- An inability to liquidate investments due to market conditions.

Subject to maintaining sufficient liquidity in aggregate across the Group's fully aligned entities, the Group has the ability to perform intra-group transactions in the event of temporary liquidity shortfalls at subsidiary undertaking level. This obviates incurring any costs that might result from raising entity-specific liquidity through external means.

As such, whilst the Group monitors and reports local liquidity levels against applicable stress events, it maintains the view that it is not necessary to cascade its formal risk tolerance and associated risk reporting requirements to subsidiary undertaking level and focuses on reporting overall Group liquidity to Group and subsidiary undertaking Boards. The Group has maintained liquidity in excess of this tolerance through its focus on maintaining a portfolio that is highly liquid, of overall short duration and highly creditworthy.

Mitigation

The Company manages its liquidity risks via its investment strategy to hold high quality, highly liquid securities, sufficient to meet its insurance liabilities and other near-term liquidity requirements. The creation of the core portfolio with its subset of guidelines aims to ensure funds are readily available to meet potential insurance liabilities in an extreme event plus other near-term liquidity requirements.

In addition, the Company has established asset allocation and maturity parameters within the investment guidelines such that the majority of the investments are in high quality assets which could be converted into cash promptly and at minimal expense. The Company monitors market changes and outlook and reallocates assets as deemed necessary. The Group also monitor and reports Group liquidity against tolerances to the LUK Board.

Monitoring

The continued effectiveness of the risk mitigation techniques is monitored by the LUK Board through their review of the quarterly ORSA report plus the quarterly management IRRC meetings. These are described more fully in Section B to this report, above.

Expected profit in future premiums

The total amount of the expected profit included in future premiums as calculated in accordance with Article 260(2) is $52,037,000.

C.5 OPERATIONAL RISK

Operational risk is the risk of loss resulting from inadequate or failed internal processes, systems or any regulatory or compliance breaches. The Company has identified and evaluated its key operational risks and these are incorporated in the risk registers and modelled directly within BLAST.

The Company has also established, and monitors compliance with, internal operational risk tolerances. The RRC reviews operational risk on at least an annual basis and operational risk is also covered in the CRO's quarterly ORSA report to the LUK Board.

Mitigation

In order to manage operational risks, the Company has implemented a robust governance framework. Policies and procedures are documented and identify the key risks and controls within processes. The Group's Internal Audit function provides independent feedback with regard to the accuracy and completeness of key risks and controls, and independently verifies the effective operation of these through substantive testing. All higher risk areas are subject to an annual audit while compliance with tax operating guidelines is audited quarterly. Frequency of audits for all other areas varies from quarterly at the most frequent to a minimum of once every three years, on a rotational basis. For more information about the internal control framework please refer to section B.4 above.

Monitoring

The continued effectiveness of the risk mitigation techniques is monitored by the LUK Board through their review of the quarterly ORSA report and the quarterly risk register approval process plus the Board's input into the Company's strategy and business plan. These are described more fully in Section B to this report, above.

C.6 OTHER MATERIAL RISKS

Strategic Risk

The Company has identified several strategic risks. These include:

- The risks that either the poor execution of the business plan or an inappropriate business plan in itself results in a strategy that fails to adequately reflect the trading environment, resulting in an inability to optimise performance, including reputational risk;
- The risks of the failure to maintain adequate capital. This includes unanticipated changes in vendor, regulatory and /or rating agency models that could result in an increase in capital requirements or a change in the type of capital required; and
- The risks of succession planning, staff retention and key man risks.

Mitigation

Business plan risk – the Company addresses the risks associated with the planning and execution of the business plan through a combination of the following:

- An iterative annual forward-looking business planning process with cross departmental involvement;
- Evaluation and approval of the annual business plan by the LUK Board of Directors;
- Regular monitoring of actual versus planned results;
- Periodic review and re-forecasting as market conditions change; and
- Feedback to senior management via the daily UMCC and fortnightly RRC meetings.

Capital management risk – risks associated with the effectiveness of the Company's capital management are mitigated as follows:

- Regular monitoring of current and prospective regulatory capital requirements;
- Oversight of capital requirements by the LUK Board of Directors;
- Ability to purchase sufficient, cost effective reinsurance;
- Maintaining contact with vendors and regulators in order to stay abreast of upcoming developments; and
- Participation in industry groups such as the International Underwriting Association.

Retention risk – the risks associated with succession planning, staff retention and key man risks are mitigated through a combination of resource planning processes and controls, including:

- The identification of key personnel with appropriate succession plans;
- The identification of key team profit generators and function holders with targeted retention packages;
- Documented recruitment procedures, position descriptions and employment contracts;
- Resource monitoring and the provision of appropriate compensation, including equity based compensation which vests over a defined time horizon; and
- Training schemes.

Monitoring

The continued effectiveness of the risk mitigation techniques for other material risk is monitored by the LUK Board through their review of the quarterly ORSA. These are described more fully in Section B to this report, above. The LUK Board is responsible for monitoring the adequacy of the Company's succession plans.

Mitigation & Monitoring

Group risks need to be considered on a case-by-case basis and as such there is no one size fits all mitigation strategy. The inclusion of group risk within the CRO's quarterly ORSA report ensures it is brought to the attention of the LHL and LUK Boards and suitable mitigation plans can be put in place.

C.7 ANY OTHER INFORMATION

Stress and sensitivity testing

A range of sensitivity, stress and scenario testing techniques were applied throughout the year in response to specific actual and proposed changes to the business strategy and risk profile.

Sensitivity testing was conducted as part of the on-going development and validation of the BLAST model, methodology and assumptions across material risk categories. This was overseen by the RRC.

Scenario testing was used to assess the risk, return and capital implications of alternative potential planning scenarios. It was supported by the use of the BLAST model and applied both within the annual business planning process and on an ad-hoc basis to support the evaluation of potential changes in business strategy. The scenarios were developed with input from across the Group's senior management team and representation from the non-executive directors. The scenarios covered the following key risk areas: insurance risk, investment risk (liquidity risk) and regulatory risk. They are predominately underwriting focussed however, which is deliberate in that underwriting is by far the most significant driver of tail risk and – given the Group's significant levels of capital surplus and relatively benign risk profile in respect of other risk categories – the natural focus in terms of stress testing the stability of the Group.

Standard stress testing was used to evaluate the impact of extreme yet plausible events and scenarios that might impact the business in order to test the resilience of the plan and evaluate alternative risk mitigation arrangements. The stress testing was supported by the use of BLAST and applied during the business planning and ORSA processes.

Reverse stress testing was focussed on deliberately deconstructing the business model to test for vulnerabilities and potential events that could make it unviable. In addition to the consideration of extreme financial loss scenarios it considered the interaction of risks such as reputational and regulatory failures and loss of key resources that might combine to make the business model unviable. It utilised a combination of quantitative and qualitative techniques.

Other

All material information regarding the Company's risk profile has been described in sections C.1-C.7 above.

D.1 ASSETS

(A) VALUE OF ASSETS

The valuation of assets in the Solvency II balance sheet is as follows:

As at 31 December	2017 $'000
Investments (excluding participations)	147,130
Reinsurance recoverables	268,082
Insurance and intermediaries receivables	19,315
Reinsurance receivables	10,855
Receivables (trade, not insurance)	1,586
Cash and cash equivalents	5,603
Any other assets, not elsewhere shown	815
Total assets	**453,386**

The valuation for solvency purposes by material class of assets is as follows:

Financial assets

Financial assets comprise the following:

As at 31 December	2017 $'000
Bonds	
Government bonds	48,963
Corporate bonds	86,609
Collateralised assets	9,059
Collective investment undertakings	2,499
Investments (excluding participations)	**147,130**
Cash and cash equivalents	5,603
Total financial assets	**152,733**

With the exception of cash and cash equivalents, financial assets are held at fair value. Prices for the Company's investment portfolio are provided by a third-party investment accounting firm whose pricing processes and the controls thereon are subject to an annual audit on both the operation and the effectiveness of those controls. In accordance with their pricing policy, various recognised reputable pricing sources are used including broker-dealers and pricing vendors. The pricing sources use bid prices where available, otherwise indicative prices are quoted based on observable market trade data. The prices provided are compared to the investment managers' pricing. The Company has not made any adjustments to any pricing provided by independent pricing services or its third-party investment managers for the year ended 31 December 2017.

Highly liquid U.S. government treasury bonds and certain highly liquid short-term investments, included within the Solvency II government bonds caption, are considered to be quoted in an active market, with quoted prices readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices representing actual and regularly occurring market transactions on an arm's length basis. Excepting collective investment undertakings and cash, the remainder of the Company's financial assets are securities with quoted prices in active markets valued in accordance with the methods described in more detail on page 39 of LUK's financial statements available on the Group's website: Lancashire Insurance Company (UK) Limited.

Collective investment undertakings comprise money market funds. Money market funds and cash and cash equivalents are carried at amortised cost. Carrying amounts approximate fair value due to the short-term nature and high liquidity of the cash balances.

For Solvency II purposes interest accrued on financial assets has been added to the carrying values.

Deferred tax

There is no deferred tax asset on the Solvency II balance sheet. The treatment and recognition of deferred tax liabilities is discussed in sections D.3.

Other assets

Other assets comprise the following:

As at 31 December	2017 $'000
Insurance and intermediaries receivables	19,315
Reinsurance receivables	10,855
Receivables (trade, not insurance)	1,586
Any other assets, not elsewhere shown	815
Total other assets	**32,571**

These are assets arising in the normal course of business. The valuation of these assets on a fair value basis does not materially differ from the values recorded in the IFRS financial statements. All receivables are current; the carrying value approximates fair value due to the short-term nature of the receivables.

Operating leases

LUK provides guarantees in respect of the obligations of LISL under three operating leases to rent office accommodation. These operating leases were assigned to a third party during 2014, but LISL retains liability for the payments in the event of the default of the third party and its guarantor. The directors believe the risk of the third party and its guarantor not meeting their obligations under the leases to be remote. The leases expire in 2021. No contingent liabilities have been recognised as they are not considered material.

Changes made to the recognition and valuation bases used or to estimations during the reporting period

There were no changes made to the recognition and valuation bases or estimation techniques used during the reporting period.

Assumptions and judgments including those about the future and other major sources of estimation uncertainty

The use of estimates in the valuation of the Company's investment portfolio is disclosed on page 18 of LUK's 31 December 2017 financial statements available on the Group's website: Lancashire Insurance Company (UK) Limited.

(B) DIFFERENCES BETWEEN VALUE FOR SOLVENCY PURPOSES AND VALUE FOR FINANCIAL STATEMENTS

The Company's financial statements are prepared in accordance with accounting principles generally accepted under IFRS as adopted by the European Union. As a result, apart from some balance sheet reclassifications and valuation adjustments required for determining reinsurance recoverables, there are no other differences between the bases, methods and main assumptions used in valuing assets from those used for Solvency II purposes. A reconciliation of the statutory accounts value of asset classes to the Solvency II valuation is set out below:

As at 31 December 2017 ($'000)	IFRS financial statements	Solvency II	Total difference	Presentation differences	Valuation differences
Deferred acquisition costs(1)	45,620	–	(45,620)	(45,620)	–
Investments (including loans and mortgages)(2)	143,939	147,130	3,191	3,191	–
Reinsurance recoverables(1)	369,037	268,082	(100,955)	(59,042)	(41,913)
Insurance and intermediaries receivables(1)	142,509	19,315	(123,194)	(123,194)	–
Reinsurance receivables(1)	38,366	10,855	(27,511)	(27,511)	–
Receivables (trade, not insurance)	–	1,586	1,586	1,586	–
Cash and cash equivalents(2)	7,984	5,603	(2,381)	(2,381)	–
Any other assets, not elsewhere shown(2)	2,774	815	(1,959)	(1,959)	–
Total assets	**750,229**	**453,386**	**(296,843)**	**(254,930)**	**(41,913)**

(1) These adjustments are all related to the Solvency II technical provisions calculation – see Section D.2 below.

(2) These presentation differences are due to alternative classification of financial assets under the Solvency II regulations, including the treatment of accrued interest and pending trades that are included in 'other assets' on an IFRS basis and within the relevant investment asset classification on a Solvency II basis. These presentation re-allocations have no impact on the Company's own funds.

D.2 TECHNICAL PROVISIONS

(A) VALUE OF TECHNICAL PROVISIONS

The Solvency II basis technical provisions are comprised of three elements:

- Claims provisions – the best estimate of loss reserves on events which have occurred by the balance sheet date including associated expenses and net of future premium;
- Premium provisions – the best estimate reserves on the remaining exposure of contracts which the Company is obligated to at the balance sheet date including associated expenses and net of future premium; and
- Risk margin or "market value margin" – an additional amount, in excess of the best estimate provisions, expected to be required by a third party in order to fund the future regulatory capital required to meet the obligations. This is calculated based on a cost of capital approach.

The valuation of technical provisions for solvency purposes for each Solvency II line of business is as follows:

As at 31 December 2017 ($'000)	Marine, aviation and transport insurance	Fire and other damage to property insurance	Credit and suretyship insurance	Non-proportional marine, aviation and transport insurance	Non-proportional property reinsurance	Total
Best estimate premium provisions						
• Gross	21,337	(4,081)	(18,407)	(1,567)	(5,279)	(7,997)
• Reinsurance recoverables	58,427	15,681	(90,799)	(18,209)	(16,836)	(51,736)
Net best estimate of premium provision	79,764	11,600	(109,206)	(19,776)	(22,115)	(59,733)
Best estimate claims provision						
• Gross	206,053	23,908	8,628	5,640	17,011	261,240
• Recoverables from reinsurance	(176,826)	(16,638)	(7,468)	(4,266)	(11,148)	(216,346)
Net best estimate of claims provisions	29,227	7,270	1,160	1,374	5,863	44,894
Risk margin	6,621	1,498	446	567	2,409	11,541
Total technical provisions	**115,612**	**20,368**	**(107,600)**	**(17,835)**	**(13,843)**	**(3,298)**

The valuation methodology for determining the technical provisions is consistent across all the Solvency II lines of business and is broadly a two-step process. The first step is determining the IFRS basis provisions, with the Solvency II provisions determined from these by applying a number of adjustments and additional data inputs. The use of the IFRS provisions is deemed a suitable starting point for Solvency II technical provisions due to their significant scrutiny from internal and external parties prior to use.

IFRS provisions for the purpose of this document and the comparison to Solvency II results (both gross and ceded to reinsurers) include the earned provisions relating to events which have occurred at the valuation date (whether reported or not) plus associated loss adjustment expenses, plus non-monetary items corresponding to 100% of the unearned premium less an allowance for the acquisition costs already paid on this unearned premium. Solvency II then adjusts the above basis (separately for gross and ceded to reinsurers amounts) to move to a discounted best estimate cashflow approach (claims, expenses and premiums) on a legally obliged (rather than inception) basis allowing for the expected value of all possible outcomes. This removes the non-monetary items and replaces these with the cashflows expected to arise from these exposures including business to which LUK is legally obliged to accept but has yet to incept.

Provisions are valued separately depending on whether claims events have occurred or are yet to occur at the valuation date. Claims events which have occurred (whether reported to the insurer or not) are known as claims provisions. Provisions in respect of future claim events are known as premium provisions.

In addition to the above 'best estimate' of the future cashflows, a risk margin is added to represent the cost of capital required to run-off the existing obligations to expiry. This adjustment is designed to increase the best estimate to a market consistent value in line with the rest of the Solvency II balance sheet.

The Group's actuarial function considers the process to determine both IFRS and Solvency II basis technical provisions as appropriate as assessed through the data governance framework and technical provision validation process. The overall approach to valuing and validating the technical provisions recognises the inherent uncertainty in assessing the size, timing and nature of future insurance cashflows, in particular for claims which have yet to occur, as described further in section (B) below.

The approach adopted recognises the principle of proportionality while ensuring compliance with the Solvency II regulations, in particular Articles 75 to 86 of the Directive. The principle of proportionality permits insurers to choose and apply valuation methods which are:

- suitable to achieve the objective of deriving a market-consistent valuation according to Solvency II principles; but
- not more sophisticated than is needed in order to reach this objective.

LUK's approach to deriving technical provisions adheres to this principle by focusing most effort on the material drivers of the valuation basis and the associated risks and sensitivities.

(B) LEVEL OF UNCERTAINTY IN VALUATION OF TECHNICAL PROVISIONS

The main driver of uncertainty within the technical provisions is the final outcome of claims both in respect of events which have occurred (whether reported or not) and which may arise in future from unexpired exposure. The Company's business and underwriting model generally results in claims which are low frequency and high severity in nature making the available historical loss data volatile and less useful for predicting ultimate losses.

In most cases, reinsurance helps in reducing the uncertainty and exposure to the Company particularly for known events where, while the gross outcome may be uncertain, the fact that reinsurance protection is in place, particularly excess of loss coverage, the net impact may be relatively stable and known. At the best estimate (i.e. mean) level it is generally expected that profit would be ceded to third party reinsurers (i.e. a higher net than gross loss ratio) as the third party reinsurance programme generally protects the Company in more extreme (i.e. above mean) outcomes. Given the nature of the Company's reinsurance programme, this provides protection against low frequency, high severity events where, upon occurrence, the reinsurance generates significant benefits to LUK. The third party excess of loss reinsurance all inures to the benefit of the QST (refer to section A5), which further reduces LUK's net exposure to loss events.

The Solvency II adjustments to the IFRS technical provisions introduce a number of areas of uncertainty either due to the uncertainty in the amounts and subjectivity of the approach or through future volatility which could vary the particular element significantly. The most appropriate approaches have been selected as described in section C below.

(I) UNCERTAINTY WITHIN THE CLAIMS PROVISIONS

In respect of claim events which have occurred, the lack of stable and reliable historical data makes predictions of ultimate losses, particularly for less well developed accident years or where there is ongoing dispute or litigation, especially uncertain. There is also a time lag inherent in reporting from the original claimant to the primary insurer to the broker and then to the reinsurer. In the case of proportional contracts, reliance is placed on an analysis of a contract's historical experience, industry information, and the professional judgement of underwriters in estimating reserves for these contracts. In addition, if available, reliance is placed partially on ultimate loss ratio forecasts as reported by insureds or cedants, which are normally subject to a quarterly or six month lag.

As a result of the time lag described above, an estimate must be made of the technical provisions. Because of the degree of reliance that is necessarily placed on insureds or ceding companies for claims reporting, the associated time lag, the low frequency/high severity nature of much of the business that the Company writes, and the varying reserving practices among ceding companies, reserve estimates are highly dependent on management judgement and are therefore uncertain. During the loss settlement period, which may be years in duration, additional facts regarding individual claims and trends often will become known, and current laws and case law may change, with a consequential impact on reserving. The claims count on the types of insurance and reinsurance that the Company writes, which are low frequency and high severity in nature, is generally low.

For certain catastrophic events there are greater uncertainties underlying the assumptions and associated estimated reserves for losses and loss adjustment expenses. Complexity resulting from problems such as policy coverage issues, multiple events affecting one geographic area and the resulting impact on claims adjusting (including the allocation of claims to the specific event and the effect of demand surge on the cost of building materials and labour) by, and communications from, insureds or ceding companies, can cause delays to the timing with which the Company is notified of changes to loss estimates.

The majority of the technical provision estimate relates to potential claims on non-elemental risks where timing delays in insured or cedant reporting may mean losses could have occurred which the company was not made aware of by the balance sheet date.

(II) UNCERTAINTY WITHIN THE PREMIUM PROVISIONS

In respect of unexpired exposure, the fact that claim events have yet to occur makes the final outcome on this exposure less certain. IFRS provisions for these by requiring their booking at a 100% loss ratio on the unearned premium. The 'best estimate cashflow' approach under Solvency II however requires provisioning for the expected level of future claims and expenses which will arise from this exposure which may then be offset by the future premium amounts.

As a result of the cashflow approach, the profit embedded in the unexpired exposures is realised immediately under Solvency II, compared to IFRS which defers this until the exposure is recognised. While the profit outcome will ultimately be the same over time, the accounting treatment differs for the balance sheet. There is a greater uncertainty in the Solvency II balance sheet with regard to unexpired exposures than on the IFRS as there is more reliance on assumptions about future claims experience.

(C) DIFFERENCES BETWEEN VALUE FOR SOLVENCY PURPOSES AND VALUE FOR FINANCIAL STATEMENTS

To determine the Solvency II technical provisions LUK takes the IFRS technical provisions and makes a number of adjustments. The differences between the accounting and Solvency II bases for technical provisions are summarised in the table below:

As at 31 December 2017 ($'000)	Gross of Reinsurance	Reinsurance Recoverables	Net of Reinsurance
i) Technical provisions – accounting basis*	407,770	(321,319)	86,451
ii) Movement of not yet due premium debtors to TPs	(96,254)	11,324	(84,930)
Total reclassification difference	**(96,254)**	**11,324**	**(84,930)**
iii) Adjustments to IFRS loss reserves for basis change	2,645	6,919	9,564
iv) Profit in respect of legally obliged future exposure	(46,009)	20,801	(25,208)
v) Allowance for reinsurer default	–	183	183
vi) Allowance for discounting at risk free rates	(14,909)	14,010	(899)
vii) Risk margin	11,541	–	11,541
Total valuation difference	**(46,732)**	**41,913**	**(4,819)**
Technical provisions – solvency basis	**264,784**	**(268,082)**	**(3,298)**

* The technical provision on an accounting basis includes; i) loss and loss adjustment expenses and unearned premiums and ii) reinsurance recoveries, unearned premiums on premiums ceded and deferred acquisition cost.

(I) IFRS PROVISIONS

Provisions for claims which have occurred by the valuation date (whether reported or not) are calculated using traditional actuarial methods on a gross and net of reinsurance basis. Attritional losses are reserved using claim development methods or the Bornhuetter-Ferguson technique whilst large losses are reserved for using exposure analyses or claim development methods. A provision is also included for the expenses associated with settling these claims.

The traditional accounting approach to business yet to be earned is to hold an UPR equivalent to 100% of the premium yet to be earned on incepted business. Where this is deemed to be insufficient, an additional provision may also be held in excess of this.

The IFRS basis technical provisions are calculated quarterly by the Deputy Group Chief Actuary. This is overseen by the LUK Reserve Committee, a management committee that reviews the reserves,with particular attention on the large events, and the approach to determining these. The reserves are then approved by the Audit Committee. Each quarter's reserve setting process is supported by backtesting of prior expectations against the actual observed experience. This is done based on the level of incurred claims (paid plus reported) compared to the amount that was anticipated for the quarter at the previous quarter end. This is used to support changes in the ultimate claim outcome estimates over time.

The Group engages an external actuary to conduct an independent review of the Group's claims reserves on an IFRS basis every six months. This analysis is included for comparison in the IBNR report to the LUK Audit Committee. Significant differences between the two estimates are discussed in the report. The external auditors, KPMG LLP, also present a comparison of Lancashire's reserves to their own best estimates at the second and fourth quarter Board meetings.

(II) MOVEMENT OF NOT YET DUE PREMIUM DEBTORS TO TECHNICAL PROVISIONS

In the IFRS statutory accounts future premiums inwards/outwards reside within the debtors/creditors balances in the balance sheet. Under the Solvency II cashflow approach, the future premium cashflows which are not due by the valuation date are reallocated to the technical provisions. Premium due at the valuation date remains in the debtors/creditors. All future (re)insurance payable and receivable balances are assumed to relate to the premium provisions within the Solvency II balance sheet.

(III) ADJUSTMENTS TO IFRS LOSS RESERVES FOR BASIS CHANGE

Adjustments to IFRS loss reserves for basis change comprises the following:

ADJUSTMENT TO ACTUARIAL BEST ESTIMATE

The IFRS reserves are moved from a management best estimate to a pure actuarial best estimate – this is done at a class of business and entity level and separately for gross and reinsurance amounts.

INCLUSION OF ADDITIONAL EXPENSES

The expense provisions are adjusted to include an allowance for all future expenses required to settle the existing insurance obligations on a going concern basis. This is naturally higher than the loss adjustment expenses included within the IFRS provisions (typically split across 'allocated' – ALAE and 'unallocated' – ULAE provisions) as it includes items such as overheads and investment management fees. The ALAE provisions are included implicitly within the loss reserves under both accounting and solvency bases.

To calculate the additional expense requirement, in excess of the IFRS provisions, the Company assumes a base level of expenses required to run off claims for the next calendar year. Relevant administration expenses are based on the budget in respect of the next calendar year and adjusted to remove the costs associated with underwriting new business and further by scaling based on an estimate of the headcount required to manage the business in a run-off situation. The base investment management expenses for the next year are assumed to be the same as the prior year amounts. Administrative expenses are assumed to re-occur annually reducing more slowly than the reduction in claims reserves to recognise the likely lag in the reduction of administrative expenses over time as the existing business runs-off. Investment management expenses are assumed to be variable and reduce in line with the future level of claims payments; this is deemed reasonable as it represents the reduction in the level of investible assets as claims are paid. The Company has used the proportionality principle and concluded that the impact of expense inflation is negligible. This is due to the short-tailed nature of the business underwritten by the Company.

Brokerage or other acquisition expenses associated with the existing premium debtors are determined when these are established in the accounts; as such these are booked net of acquisition costs. No further allowance for acquisition costs on (re)insurance receivables and payables is made in the technical provisions.

(IV) PROFIT IN RESPECT OF LEGALLY OBLIGED FUTURE EXPOSURE

REMOVAL OF UPR AND DAC

Under Solvency II the full cashflows associated with the unearned premium provisions must be valued and accounted for rather than accounting for non-monetary items such as gross and ceded UPR and DAC. This removes an element of prudence in the accounting basis technical provisions and recognises the anticipated profit embedded within this business at the valuation date rather than deferring this recognition as the exposure is recognised. For the Solvency II technical provisions the accounting concepts of UPR and DAC are therefore replaced with the expected future claims and associated expenses arising from the unearned exposure described below.

INCLUSION OF CLAIMS ASSOCIATED WITH UPR

Gross and net premium provisions are calculated using expected ultimate ratios by line of business applied to the unearned premium. The loss ratios are sourced from the business plan and represents the best estimate view (i.e. mean of the distribution of future outcomes) of the losses likely to emerge in future periods and as such are deemed a reasonable assumption to use. The Events Not In Data ('ENID') uplift, see below, is applied to these ratios to move this to an 'all outcomes' basis.

INCLUSION OF FUTURE REINSURANCE PREMIUM COVERING FUTURE EXPOSURE ON EXISTING LEGAL OBLIGATIONS

Credit is being taken in the technical provisions for recoveries on expected future claims events which have yet to occur. These events may occur a number of years in the future and are potentially covered by reinsurance to be purchased in these future years, notably contracts on an Losses Occurring basis. As a consequence, an allowance needs to be made in the technical provisions for the share of this planned future reinsurance premium which covers the future exposure on the existing obligations. This is done by apportioning the business plan future reinsurance premium spend between current and future inwards obligations through an analysis of the gross premium earnings over time and, at each time point, how much relates to existing obligations at the valuation date.

The future reinsurance premiums, split between the risk premium and any brokerage/commissions (using ratios from the business plan) are deducted from the claims and expenses to determine the best estimate provision.

ALLOWANCE FOR EVENTS NOT IN DATA

The IFRS technical provisions allow for the best estimate of 'reasonably foreseeable' outcomes whereas Solvency II requires the best estimate of 'all possible outcomes'. This implicitly includes a wider range of events in the future claim estimates and introduces the concept of an ENID allowance in the solvency provisions. This may include latent claims or very extreme high severity/low probability claims but more widely any event not observed in the historical data. An ENID uplift is added to the premium provision to recognise the additional uncertainty in the unearned exposure compared to the claims provisions. No allowance for ENID is added to the claims provisions. Given the short tailed generally catastrophe driven nature of the business written by the Company additional provisions above IFRS amounts are deemed negligible.

ENID uplift ratios are calculated separately for each line of business and are applied to the premium provisions. The ratios are calculated using the ratio of the mean of the full range of outcomes from the Company's capital model ('BLAST') to the mean of a range where outcomes above the 99.5th percentile are truncated. This therefore allows for modelled events over the 1 in 200 outcome level that is used for IFRS reserving. The same uplift proportions are applied gross and net of reinsurance.

FUTURE CASHFLOW FROM UNINCEPTED LEGAL OBLIGATIONS

Contract boundaries for Solvency II purposes are defined as all contracts to which the Company is legally obligated to accept as at the balance sheet date. It therefore includes contracts which may not have incepted but where the insurer no longer has a unilateral right to cancel the contract, reject the premium and amend the premiums or benefits payable under the contract to reflect the underlying risks. For the Company this means that in addition to the claims provisions and unearned portion of in-force business, cashflows also need to be considered in relation to business which has not incepted but where the rights as outlined above do not hold. The Company's underwriting system records such policies providing an up-to-date and accurate view of the nature and scale of this business.

To determine the technical provision allowance for this element, the future premium on policies which have been agreed prior, but incept after, the valuation date is taken from the underwriting system as the exposure measure. Similar to the incepted approach with UPR, this unincepted future premium is multiplied by the ultimate loss ratio in the business plan and uplifted by the ENID ratios to determine the future claims. By applying a loss ratio to the full future premium an implicit assumption is made that there is no lapse risk, therefore all contracts which have been bound will be taken up. This is deemed suitable due to the use of the live underwriting system at the valuation date to indicate which policies are legally bound.

The unincepted legal obligations receive a share of the allocated expenses as described in (iii) above.

The future premium is taken net of the acquisition cost and deducted from the claims and expenses to determine the best estimate provision. Note that in most cases the future premium on this business will exceed the expected claims and expenses. In this case the contribution of the unincepted premium provisions to the overall technical provisions will be negative.

(V) ALLOWANCE FOR REINSURER DEFAULT

An allowance is added for credit default risk on reinsurance recoverables in the balance sheet. Recoverables are identified by class based on the gross and net future claims modelling as derived through the accounting and solvency reserving processes.

Use of simplified method

The following assumptions are made to derive the allowance:

- All counterparties have the same annual probability of default, equivalent to an A-rated counterparty in line with the Solvency Capital Requirement ('SCR') calculation;
- A recovery rate of 50% upon default in line with the SCR calculation;
- Default occurring at a future date equal to the modified duration of the recoveries; and
- A constant probability of default in future years.

This adjustment and the assumptions used to derive it ensure consistency between the technical provisions and SCR calculations for the Company. Further, the approach is deemed proportionate given the generally low utilisation of outwards reinsurance at the mean (as the technical provisions target) by the Company and also given the low levels of industry default data on which to derive another, more representative and accurate assumption.

(VI) ALLOWANCE FOR DISCOUNTING AT RISK FREE RATES

The undiscounted future claim, premium and expense amounts are derived, as described above, by class of business and the most material currencies. The material currencies are assessed prior to each valuation based on an assessment of the existing claims and exposure. At 2017 year-end the provisions were derived explicitly in fourteen separate currencies. All non-material currencies are grouped together and discounted using a U.S. dollar risk-free yield curve.

Cashflow patterns are applied to these to determine the timing of payments and receipts. The claim and premium cashflow pattern assumptions are sourced from BLAST, expense cashflow pattern assumptions are described in (vii) below. Reinsurance recoveries are assumed to occur 3 months after the gross claim cashflow. Future cashflows are assumed to occur mid-way through the year.

The present value of the projected cash flows is determined by discounting each currencies' cashflows using yield curves which are published quarterly on EIOPA's website. The unadjusted risk-free yield curves are used (i.e. no application of volatility or matching adjustments), this is the same yield curve used for the application of shocks to the assets and liabilities for the purpose of interest rate risk in the Standard Formula of the SCR calculation.

(VII) RISK MARGIN

The best estimate technical provisions on the Solvency II basis are supplemented by the risk margin, representing the cost of capital which a third party would incur in taking over and running the existing obligations to expiry. The risk margin is calculated by determining the cost of providing an amount of eligible own funds equal to the SCR necessary to support the Company's current insurance obligations over their lifetime. This is derived through assuming the obligations are transferred to a 'reference undertaking' at the valuation date who has no existing obligations, does not intend to write further business and is able to invest assets to minimise its market risk. All associated reinsurance is also assumed to be transferred. The rate used to determine the cost of providing the amount of eligible own funds is called the Cost-of-Capital rate and is prescribed in the Solvency II Regulations (currently at 6%).

The key judgement for the calculation of the risk margin is determining the starting SCR and further, how the future SCR, in respect of the obligations at the valuation date, develops over time.

The starting t=0 SCR is scaled to remove risk associated with business not yet bound and market risk is removed completely. Operational and counterparty default risks remain. The risks are re-aggregated in line with the SCR correlation matrix. Future SCRs are adjusted to remove insurance risks associated with the underwriting of new business and its remaining exposure which would be nil after the first year on obligated business at the t=0 valuation date.

Use of simplified method

The future SCR charges for each calendar year will reduce more slowly than the run-off of future claims. For example, an element of operational risk would remain more 'fixed' than the claims run-off would represent and further, reserve risk is likely to increase as technical provisions reduce as any single claim would increase the overall volatility and the provisions which take longer to settle are likely to be on more contentious claims. To account for this, LUK assumes the SCRs beyond time 0 are proportional to the square root of the remaining claims reserves since time 0.

This simplification is used as the explicit calculation of every year's SCR to runoff would hugely increase the complexity required to calculate the technical provisions. As LUK would have zero unavoidable market risk, reserve risk would be the largest driver of the SCR in runoff. The counterparty default risk is highly correlated with underwriting risk; therefore in a runoff situation with no underwriting risk, the counterparty default risk would also reduce significantly. The operational risk would also be expected to reduce in run-off as the business volumes and reserves declined. As the SCR would be driven by reserving risk, then an approach to derive the future SCRs which is a function of the run-off of the technical provisions is deemed appropriate. The slower SCR decay pattern (using the square root of the payment pattern) allows for the increasing volatility of risk as the provisions reduce (e.g. due to a 'fixed' nature of operational risk and the likelihood for more uncertainty in the reinsurance recoveries on the claims which take longer to settle).

The calculation is then completed by discounting the future SCRs using the risk-free yield curves provided by EIOPA (a U.S. dollar curve is used as this dominates the Group's capital base) and applying the cost of capital provided by EIOPA (6%). The risk margin is the sum of each future year's discounted cost of capital. For reporting purposes, this is then allocated to class in proportion to the the net future claims.

(VIII) OTHER CASHFLOWS

Cashflows relating to salvage and subrogation, and those relating to tax payments to be charged to policyholders or which are required to settle insurance or reinsurance obligations are judged to be immaterial based on the Company's past history and are therefore excluded from the technical provision calculation.

Differences between value for solvency purposes and value for financial statements by Solvency II lines of business

The quantitative differences between the accounting and Solvency II bases for technical provisions by Solvency II lines of business are summarised in the tables below. The qualitative description above is applicable for all the Solvency II lines of business as there is no difference in methodology across the book.

Marine, aviation & transport insurance As at 31 December 2017 ($'000)	Gross of Reinsurance	Reinsurance Recoverables	Net of Reinsurance
i) Technical provisions – accounting basis*	276,080	(222,693)	53,387
ii) Movement of not yet due premium debtors to TPs	(32,572)	95,814	63,242
Total reclassification difference	**(32,572)**	**95,814**	**63,242**
iii) Adjustments to IFRS loss reserves for basis change	(575)	3,884	3,309
iv) Profit in respect of legally obliged future exposure	(3,820)	(6,167)	(9,987)
v) Allowance for reinsurer default	–	135	135
vi) Allowance for discounting at risk free rates	(11,723)	10,628	(1,095)
vii) Risk margin	6,621	–	6,621
Total valuation difference	**(9,497)**	**8,480**	**(1,017)**
Technical provisions – solvency basis	**234,011**	**(118,399)**	**115,612**

* The technical provision on an accounting basis includes; i) loss and loss adjustment expenses and unearned premiums and ii) reinsurance recoveries, unearned premiums on premiums ceded and deferred acquisition cost.

Fire and other damage to property insurance As at 31 December 2017 ($'000)	Gross of Reinsurance	Reinsurance Recoverables	Net of Reinsurance
i) Technical provisions – accounting basis*	44,727	(32,165)	12,562
ii) Movement of not yet due premium debtors to TPs	(11,963)	20,576	8,613
Total reclassification difference	**(11,963)**	**20,576**	**8,613**
iii) Adjustments to IFRS loss reserves for basis change	2,086	1,329	3,415
iv) Profit in respect of legally obliged future exposure	(14,022)	8,474	(5,548)
v) Allowance for reinsurer default	–	13	13
vi) Allowance for discounting at risk free rates	(1,001)	816	(185)
vii) Risk margin	1,498	–	1,498
Total valuation difference	**(11,439)**	**10,632**	**(807)**
Technical provisions – solvency basis	**21,325**	**(957)**	**20,368**

* The technical provision on an accounting basis includes; i) loss and loss adjustment expenses and unearned premiums and ii) reinsurance recoveries, unearned premiums on premiums ceded and deferred acquisition cost.

Credit & suretyship insurance As at 31 December 2017 ($'000)	Gross of Reinsurance	Reinsurance Recoverables	Net of Reinsurance
i) Technical provisions – accounting basis*	61,129	(46,261)	14,868
ii) Movement of not yet due premium debtors to TPs	(39,008)	(73,847)	(112,855)
Total reclassification difference	**(39,008)**	**(73,847)**	**(112,855)**
iii) Adjustments to IFRS loss reserves for basis change	(1,204)	580	(624)
iv) Profit in respect of legally obliged future exposure	(29,077)	19,175	(9,902)
v) Allowance for reinsurer default	–	23	23
vi) Allowance for discounting at risk free rates	(1,619)	2,063	444
vii) Risk margin	446	–	446
Total valuation difference	**(31,454)**	**21,841**	**(9,613)**
Technical provisions – solvency basis	**(9,333)**	**(98,267)**	**(107,600)**

* The technical provision on an accounting basis includes; i) loss and loss adjustment expenses and unearned premiums and ii) reinsurance recoveries, unearned premiums on premiums ceded and deferred acquisition cost.

The 'negative' net technical provisions on this class are due to there being significant amounts of future premium incorporated into the provisions, reflecting the generally long term nature of the underlying deals.

Non-proportional marine, aviation & transport Reinsurance As at 31 December 2017 ($'000)	Gross of Reinsurance	Reinsurance Recoverables	Net of Reinsurance
i) Technical provisions – accounting basis*	10,671	(7,853)	2,818
ii) Movement of not yet due premium debtors to TPs	(7,317)	(14,367)	(21,684)
Total reclassification difference	**(7,317)**	**(14,367)**	**(21,684)**
iii) Adjustments to IFRS loss reserves for basis change	(66)	335	269
iv) Profit in respect of legally obliged future exposure	985	(723)	262
v) Allowance for reinsurer default	–	8	8
vi) Allowance for discounting at risk free rates	(200)	125	(75)
vii) Risk margin	567	–	567
Total valuation difference	**1,286**	**(255)**	**1,031**
Technical provisions – solvency basis	**4,640**	**(22,475)**	**(17,835)**

* The technical provision on an accounting basis includes; i) loss and loss adjustment expenses and unearned premiums and ii) reinsurance recoveries, unearned premiums on premiums ceded and deferred acquisition cost.

Non-proportional property reinsurance As at 31 December 2017 ($'000)	Gross of Reinsurance	Reinsurance Recoverables	Net of Reinsurance
i) Technical provisions – accounting basis*	15,163	(12,347)	2,816
ii) Movement of not yet due premium debtors to TPs	(5,394)	(16,852)	(22,246)
Total reclassification difference	**(5,394)**	**(16,852)**	**(22,246)**
iii) Adjustments to IFRS loss reserves for basis change	2,404	791	3,195
iv) Profit in respect of legally obliged future exposure	(75)	42	(33)
v) Allowance for reinsurer default	–	4	4
vi) Allowance for discounting at risk free rates	(366)	378	12
vii) Risk margin	2,409	–	2,409
Total valuation difference	**4,372**	**1,215**	**5,587**
Technical provisions – solvency basis	**14,141**	**(27,984)**	**(13,843)**

* The technical provision on an accounting basis includes; i) loss and loss adjustment expenses and unearned premiums and ii) reinsurance recoveries, unearned premiums on premiums ceded and deferred acquisition cost.

(D) PRESCRIBED STATEMENTS

The matching adjustment referred to in Article 77b of Directive 2009/138/EV is not used by the undertaking.

The volatility adjustment referred to in Article 77d of Directive 2009/138/EC is not used by the undertaking.

The transitional risk-free interest rate-term structure referred to Article 308c of Directive 2009/138/EC is not applied by the undertaking.

The transitional deduction referred to in Article 308d of Directive 2009/138/EC is not applied by the undertaking.

(E) RECOVERABLES

Reinsurance recoverables consist of amounts due from reinsurers for third party reinsurance. They comprise reinsurers' share of premium and claims provisions and are calculated as the difference between the gross and net amounts using the same methodology as the underlying claims and premium provisions.

Reinsurance recoveries on gross reported claims are determined when the gross losses are assessed. The recoveries on future unreported claims (on both incepted and unincepted but legally obliged unearned business) are determined by applying reinsurance/gross claims ratios to the gross claims. The ratios are sourced from BLAST consistently with the gross amounts.

Section D.2.C.(II) above describes the movement of reinsurance payable and receivables in to the Solvency II basis technical provisions. Section D.2.C.(IV) above describes how the future reinsurance premium covering future exposure on existing legal obligations has been included in the Solvency II technical provisions. An allowance is given for credit default risk on reinsurance recoverables as described in Section D.2.C. (V) above.

(F) MATERIAL CHANGES IN CALCULATION ASSUMPTIONS

In a change to our technical provision valuation since 31 December 2016, the Group, in line with practice elsewhere in the market, now recognises a difference between management and actuarial best estimates in the transition from IFRS to Solvency II bases.

D.3 OTHER LIABILITIES

(A) VALUE OF LIABILITIES

The valuation of liabilities in the Solvency II balance sheet is as follows:

As at 31 December	2017 $'000
Technical Provisions	264,784
Insurance & intermediaries payables	–
Payables (trade, not insurance)	5,411
Deferred tax liabilities	2,024
Other liabilities	949
Total Liabilities	**273,168**

(I) LIABILITIES EXCLUDING TECHNICAL PROVISIONS

All liabilities are valued for solvency purposes on the same basis as for accounting purposes since the carrying value approximates market value due to their short-term nature. All liabilities are due to be paid in less than one year.

Changes made to the recognition and valuation bases used or to estimations during the reporting period

There were no changes made to the recognition and valuation bases or estimation techniques used during the reporting period.

Assumptions and judgments including those about the future and other major sources of estimation uncertainty

There is no material use of estimates or future assumptions and judgements in the valuation of the Company's other liabilities.

Leasing arrangements

The Company's operating lease arrangements are disclosed in section D.1 (A) above. There are no material liabilities arising as a result of leasing arrangements.

Deferred tax liabilities

As at 31 December	2017 $'000
Deferred tax	
Capital allowances	(208)
Claims Equalisation Reserves	1,308
Unrealised investment gains	105
Solvency II valuation adjustment	819
Total deferred tax	**2,024**

Deferred tax is recognised on temporary differences between the assets and liabilities in the balance sheet (i.e. on an IFRS basis) and their tax base. Deferred tax assets are recognised to the extent that realising the related tax benefit through future taxable profits is likely. The information in the three year forecast for the UK entities is assessed when making the decision on whether future taxable profit is likely.

At 31 December 2017 timing differences were made up of claims equalisation reserves and unrealised investment gains that will be taxed in future years and capital allowances that will be deducted for tax purposes in the future.

The UK corporation tax rate as at 31 December 2017 was 19% (effective from 1 April 2017). Until 1 April 2017, the UK corporation tax rate of 20% applied. The UK government has passed legislation to reduce the rate of corporation tax to 17% with effect from 1 April 2020. These rates have been applied in the closing deferred tax position on the balance sheet.

The deferred tax liabilities are short term in nature and will typically reverse within a 3 to 4 year period.

Liabilities for employee benefits
The Company does not have any material liabilities for employee benefits and does not have a defined benefit pension scheme.

(B) DIFFERENCES BETWEEN VALUE FOR SOLVENCY PURPOSES AND VALUE FOR FINANCIAL STATEMENTS

The differences between liabilities on an IFRS basis and the Solvency II valuation are summarised in the table below:

As at 31 December 2017 ($'000)	IFRS financial statements	Solvency II	Total difference	Presentation differences	Valuation differences
Technical provisions	453,390	264,784	(188,606)	(141,874)	(46,732)
Deferred tax liabilities	1,205	2,024	819	–	819
Insurance & intermediaries payables	26,940	–	(26,940)	(26,940)	–
Reinsurance payable	38,834	–	(38,834)	(38,834)	–
Payables (trade, not insurance)	5,923	5,411	(512)	(512)	–
Any other liabilities, not elsewhere shown	47,718	949	(46,769)	(46,769)	–
Total liabilities	**574,010**	**273,168**	**(300,842)**	**(254,929)**	**(45,913)**

The key differences in liabilities between the Solvency II balance sheet and the IFRS basis are related to the technical provisions valuation as further analysed in the technical provisions section above.

D.4 ALTERNATIVE METHODS FOR VALUATION

The valuation methodologies for the Company's material classes of assets are disclosed in Section D.1. above, the technical provisions in Section D.2 above and material classes of liabilities in section D.3 above, including any alternative methods for valuation.

D.5 ANY OTHER INFORMATION

All material information regarding the valuation of assets and liabilities for solvency purposes has been disclosed in sections D.1-D.4 above. The Company does not have any material off-balance sheet liabilities.

E.1 OWN FUNDS

(A) MANAGEMENT OF OWN FUNDS

LUK is part of a Group that actively reviews the level and composition of capital on an ongoing basis. Decisions on optimal capital levels are also an integral part of the Group's business planning process which covers a 3 year time horizon. Due to the QST which materially reduces LUK's capital requirements, the Group's management of own funds is relevant to the Company.

The key aim of the Group's 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.

LUK's capital requirement and capital headroom is primarily driven by its Solvency II SCR and is monitored throughout the year. In addition to the annual SCR which is reported, the SCR is updated for internal purposes at 30 June each year. The capital requirement and headroom are projected for 3 years as part of the planning process. Based on these projections no capital actions are required.

There have been no material changes in the approach to capital management over the reporting period.

(B) STRUCTURE , AMOUNT AND QUALITY OF OWN FUNDS BY TIER

Total basic eligible own funds of the Company as at 31 December 2017 amounted to $180,218,000. The Company's own funds are comprised of:

As at 31 December	2017 $'000	2016 $'000	Difference $000
Tier 1 Capital			
Ordinary share capital	188,442	188,442	–
Reconciliation reserve	(8,224)	(20,434)	12,210
Total basic eligible own Funds to meet MCR	**180,218**	**168,008**	**12,210**
Tier 3 Capital			
Deferred tax asset	–	224	(224)
Total basic eligible Own Funds to meet SCR	**180,218**	**168,232**	**11,986**

Ordinary share capital comprises allocated, called up and fully paid ordinary shares. Ordinary share capital is the highest quality of capital available and does not have a duration.

The Company does not have any ancillary own funds.

The key elements of the reconciliation reserve are as follows:

As at 31 December	2017 $'000	2016 $'000	Difference $000
Total assets (section D1)	453,386	536,177	(82,791)
Total liabilities (section D3)	(273,168)	(367,945)	94,777
Excess assets over liabilities ("Own Funds")	180,218	168,232	11,986
Share capital	(188,442)	(188,442)	–
Total reconciliation reserve and deferred tax asset	**(8,224)**	**(20,210)**	**11,986**

The increase in the excess of assets over liabilities of $11,986,000 is largely due to:

For the year ended 31 December	2017 $'000
Increase in IFRS shareholders equity	1,135
Changes in the movement of technical provisions to a Solvency II basis.	11,585
Valuation adjustments relating to Deferred Tax	(819)
Other	85
Change in the excess of assets over liabilities	**11,986**

The Company's own funds are wholly eligible to meet the Solvency Capital Requirement and the Minimum Capital Requirement. Furthermore, all Tier 1 capital is permanently available to cover losses.

(C) ELIGIBLE OWN FUNDS TO COVER SCR BY TIER

The total Tier 1 own funds of $180,218,000 are eligible to cover the SCR.

(D) ELIGIBLE OWN FUNDS TO COVER MCR BY TIER

The total Tier 1 own funds of $180,218,000 are eligible to cover the MCR.

(E) RECONCILIATION OF EXCESS OF ASSET OVER LIABILITIES ON A SII BASIS AND SHAREHOLDERS' EQUITY ON AN IFRS BASIS

Solvency II own funds represent the excess of Solvency II assets over liabilities. The reconciliation of the IFRS valuation of shareholders' equity to the Solvency II valuation of own funds is shown below:

As at 31 December	2017 $'000	2016 $'000	Difference $000
IFRS shareholders' equity	**176,218**	**175,083**	**1,135**
Valuation adjustments relating to technical provisions	4,819	(6,766)	11,585
Valuation adjustments relating to Deferred Tax	(819)	–	(819)
Other	–	(85)	85
Solvency II eligible Own Funds	**180,218**	**168,232**	**11,986**

The valuation adjustments relating to technical provisions are detailed in Section D.2.C above.

(F) DEDUCTIONS FROM OWN FUNDS

Solvency II requires an adjustment to be made to own funds to allow for assets that may be encumbered and/or restricted and therefore not available to meet risks/liabilities of the Company. The Company has no non-available own funds.

(G) ADDITIONAL INFORMATION ON GROUP OWN FUNDS

All relevant information concerning the Company's own funds has been provided above.

E.2 SOLVENCY CAPITAL REQUIREMENT AND MINIMUM CAPITAL REQUIREMENT

(A) SCR AND MCR

Lancashire's SCR as at 31 December 2017 is $87,290,000 and its MCR is $21,823,000. With eligible own funds of $180,218,000, the SCR coverage ratio is 206.5%. The final amount of the SCR as at 31 December 2017 is still subject to supervisory assessment. Lancashire does not utilise any Undertaking Specific Parameters in accordance with Article 110 of the Solvency II Directive.

(B) SCR SPLIT BY RISK MODULE

The table below shows the breakdown of the SCR in to its component risk modules:

As at 31 December	2017 $'000
Underwriting risk	64,763
Market risk	13,727
Counterparty default risk	17,163
Operational risk	7,597
Undiversified Solvency Capital Requirement	**103,250**
Diversification credit	(15,960)
Solvency Capital Requirement	**87,290**

Diversification benefits

The nature of LUK's business means that it is exposed to uncertainty, at least to some degree, across all areas of its balance sheet, most notably through its exposure to high severity, low frequency insurance events which can severely impact profits. In addition to insurance events, the business's financial statements are exposed to potential shocks from the investment portfolio, failure of counterparties and failure of internal systems or processes amongst others. Shocks can either arise as stand-alone events or as secondary impacts from preceding events (e.g. a reinsurer default following a significant industry loss event). Fortunately, while extreme shocks from single events are expected from time to time, multiple events occurring in the same financial period are expected less frequently. Further, while downside risk is often greater than upside, offsets can occur across the financial statements which help to dampen the impact of any single event (e.g. profitable investment income offsetting an insurance loss or a wider book of profitable insurance business offsetting the loss from a single policy or event). The concept of pooling of risks and diversification is a key attribute of insurance.

The Company uses a number of controls and systems to minimise the risk and impact of any single loss event (e.g. daily underwriter meetings, limits on exposures to any single counterparty, purchasing of reinsurance etc.), however it acknowledges that these losses will still occur. Controls and systems are also used to limit the impact of multiple shocks occurring at the same time. These include, but are not limited to:

- Monitoring of aggregate exposures to single perils or events to ensure that overall these stay within stated risk appetites and tolerances;
- Writing a geographically diverse book of business;
- Offering a diversified range of insurance products so as to spread exposure to any single class of business;
- Focussing on short tail insurance lines to mitigate against the significant risk of reserve deterioration across historic exposure periods;
- Arranging a number of additional reinstatements on reinsurance programmes so coverage remains following a significant first loss; and
- Investing in a diversified range of financial instruments which are not heavily correlated with insurance markets.

Credit is taken for the diverse nature of the exposures and lower probability of multiple extreme shocks occurring in the same year in deriving the SCR. Individual sub-components are derived as stand-alone '1 in 200 year' events over a one-year time horizon, that is, over one year, they are expected to have a probability of occurrence of 0.5%. As the individual sub-components are aggregated in deriving the SCR, diversification credit is given for the significantly lower probability that these events occur in the same year such that the final SCR is significantly lower than the sum of each of the sub-components. Diversification credit in the standard formula SCR calculation is prescribed and LUK's calculation uses the factors and methods as mandated by the requirements.

(C) STANDARD FORMULA SIMPLIFICATIONS

The key simplification employed by LUK in its SF SCR calculation is that no diversification credit is taken for having catastrophe risk exposure in different geographical regions of individual European countries for direct & proportional business. Furthermore, LUK uses the premium volume based approach for all direct and proportional natural catastrophe exposures instead of the sum insured approach by region within Europe. The Company's European exposure to catastrophe losses from its direct and proportional lines of business is small compared to its exposure in other geographical regions and in the Non-Proportional reinsurance classes. We therefore believe that any approach to implement the sum insured methodology by European region would be disproportionate to its impact on the SCR results.

Counterparty default risk also uses a simplification for the stressed recoveries according to Article 107 of the Delegated Regulations. This assumes that recoveries under stressed insurance risk can be distributed in line with the existing balance sheet exposures to the reinsurance counterparties. Although simplistic due to the use of primarily non-proportional reinsurance where the counterparties will vary as the losses suffered increase, the ratings of these undertakings are not materially different to the existing balance sheet exposures (primarily AA or A rated entities). As a result the Type 1 charge would not be materially different under a full calculation of the risk mitigating effect. The difference between the full calculation and the simplification would be further dampened through diversification up to the aggregated SCR level.

With respect to spread risk on structured products: Instead of a full cashflow for each asset-backed security, cashflows have been derived which match the duration of each security. These are a weighted average of the time steps each side of the stated duration.

(D) MCR INPUTS

The MCR targets an 80% VaR over a one-year time horizon.

The MCR is based on proportions of net written premium in the previous 12 months and net best estimate of technical provisions at the valuation date. These are supplied by Solvency II class of business with the proportions varying by class. The MCR is set with reference to a 25% – 45% collar around the SCR, which applies to LUK's calculation; as such LUK's MCR moves in line with the SCR.

(E) MATERIAL CHANGES IN THE SCR AND MCR OVER THE REPORTING PERIOD

The components of the SCR as at 31 December 2017 compared to 31 December 2016 are detailed below:

As at 31 December	2017 $'000	2016 $'000	Difference $'000
Underwriting risk	64,763	49,905	14,858
Market risk	13,727	10,953	2,774
Counterparty default risk	17,163	17,223	(60)
Operational risk	7,597	10,499	(2,902)
Undiversified Solvency Capital Requirement	**103,250**	**88,580**	**14,670**
Diversification credit	(15,960)	(13,782)	(2,178)
Solvency Capital Requirement	**87,290**	**74,798**	**12,492**
Minimum Capital Requirement	**21,823**	**18,699**	**3,124**

As noted in section C.1 of this report underwriting risk dominates the Company's risk profile. The increase since the December 2016 valuation is due to changes in methodology for non-life lapse risk during 2017.

E.3 USE OF THE DURATION-BASED EQUITY RISK SUB-MODULE IN THE CALCULATION OF THE SOLVENCY CAPITAL REQUIREMENT

The duration-based equity risk sub-module does not apply to LUK.

E.4 DIFFERENCES BETWEEN THE STANDARD FORMULA AND ANY INTERNAL MODEL USED

LUK does not have an approved internal model to calculate its Solvency Capital Requirement and therefore this section is not applicable.

E.5 NON-COMPLIANCE WITH THE MINIMUM CAPITAL REQUIREMENT AND NON-COMPLIANCE WITH THE SOLVENCY CAPITAL REQUIREMENT

The Company complied with the SCR and MCR at all times during the reporting period.

E.6 ANY OTHER INFORMATION

The PRA has exercised the option not to require disclosure of capital add-ons for periods ending up to 31 December 2020.

The Company does not have any capital add-ons imposed in accordance with Article 37 of the Solvency II Directive.

All material information regarding the valuation of assets and liabilities for solvency purposes has been disclosed in section D above.

APPENDIX 1: ANNUAL QUANTITATIVE REPORTING TEMPLATES

See attached annual QRTs in $000's

APPENDIX 2: COMPOSITION OF LUK COMMITTEES

	Audit	Remuneration	Executive Management	Regulatory Reporting & Oversight
David Sharp	Yes	Yes*		Yes
Steve Smart	Yes			Yes
Samantha Hoe-Richardson	Yes*			
Paul Gregory		Yes	Yes*	Yes
Michael Connor			Yes	Yes
Hayley Johnston			Yes	Yes
Russell Worsley			Yes	Yes*
Steve Yeo			Yes	
Adrian Colosso		Yes		
Jas Bolla – Non Director			Yes	
Louise Wells – Non Director				Yes

* Chair

APPENDIX 3: GLOSSARY

AGGREGATE
Accumulations of insurance loss exposures which result from underwriting multiple risks that are exposed to common causes of loss

AGM
Annual General Meeting

AIR
AIR Worldwide

A.M. BEST COMPANY (A.M. BEST)
A.M. Best is a full-service credit rating organisation dedicated to serving the financial services industries, focusing on the insurance sector

BEST LANCASHIRE ASSESSMENT OF SOLVENCY OVER TIME (BLAST)
The Group's economic internal capital model

BMA
Bermuda Monetary Authority

CEDED
To transfer insurance risk from a direct insurer to a reinsurer and/or from a reinsurer to a retrocessionaire

CEO
Chief Executive Officer

CFO
Chief Financial Officer

THE CODE
UK Corporate Governance Code published by the UK FRC

COMBINED RATIO
Ratio, in per cent, of the sum of net insurance losses, net acquisition expenses and other operating expenses to net premiums earned

CRO
Chief Risk Officer

CUL
Cathedral Underwriting Limited

CUO
Chief Underwriting Officer

DEFERRED ACQUISITION COSTS (DAC)
Costs incurred for the acquisition or the renewal of insurance policies (e.g. brokerage and premium taxes) which are deferred and amortised over the term of the insurance contracts to which they relate

DURATION
Duration is the weighted average maturity of a security's cash flows, where the present values of the cash flows serve as the weights. The effect of the convexity, or sensitivity, of the portfolio's response to changes in interest rates is also factored in to the calculation

EXCESS OF LOSS
Reinsurance or insurance that indemnifies the reinsured or insured against all or a specified portion of losses on an underlying insurance policy in excess of a specified amount

EXPENSE RATIO
Ratio, in per cent, of other operating expenses to net premiums earned

FACULTATIVE REINSURANCE
A reinsurance risk that is placed by means of a separately negotiated contract as opposed to one that is ceded under a reinsurance treaty

FCA
Financial Conduct Authority

FSMA
The Financial Services and Markets Act 2000 (as amended from time to time)

GROSS PREMIUMS WRITTEN
Amounts payable by the insured, excluding any taxes or duties levied on the premium, including any brokerage and commission deducted by intermediaries

THE GROUP
LHL and its subsidiaries

HMRC
Her Majesty's Revenue & Customs

IFRS
International Financial Reporting Standard(s)

IGPIA
International Group of Protection and Indemnity Associations

INCURRED BUT NOT REPORTED (IBNR)
These are anticipated or likely losses that may result from insured events which have taken place, but for which no losses have yet been reported. IBNR also includes a reserve for possible adverse development of previously reported losses

INDUSTRY LOSS WARRANTY (ILW)
A type of reinsurance or derivative contract through which one party will purchase protection based on the total loss arising from an event to the entire insurance industry rather than their own losses

INTERNAL AUDIT CHARTER
Is a formal written document that sets out the mission, scope, responsibilities, authority, professional standards and the relationship with the external auditors / regulatory bodies of the internal audit function ("internal audit") with the Company and its subsidiaries

INTERNATIONAL ACCOUNTING STANDARD(S) (IAS)
Standards, created by the IASB, for the preparation and presentation of financial statements

INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)
An international panel of accounting experts responsible for developing IAS and IFRS

IRRC
Investment Risk and Return Committee

ISA
International Standards on Auditing (UK and Ireland)

APPENDIX 3: GLOSSARY

KCM
Kinesis Capital Management Limited

LANCASHIRE COMPANIES
Refers to the Group excluding Cathedral and Kinesis

LICL
Lancashire Insurance Company Limited

LIHL
Lancashire Insurance Holdings (UK) Limited

LIMSL
Lancashire Insurance Marketing Services Limited

LISL
Lancashire Insurance Services Limited

LLOYD'S
The Society of Lloyd's

LMSCL
Lancashire Management Services (Canada) Limited

LOC
Letter of credit

LOSSES
Demand by an insured for indemnity under an insurance contract

LSE
London Stock Exchange

LTIP
Long-term incentive plan

LUK
Lancashire Insurance Company (UK) Limited

NET ACQUISITION COST RATIO
Ratio, in per cent, of net acquisition expenses to net premiums earned

NET LOSS RATIO
Ratio, in per cent, of net insurance losses to net premiums earned

NET OPERATING PROFIT
Profit before tax excluding realised gains and losses and foreign exchange gains and losses

NET PREMIUMS WRITTEN
Net premiums written is equal to gross premiums written less outwards reinsurance premiums written

ORSA
Own Risk and Solvency Assessment

PML
Probable maximum loss

PRA
Prudential Regulation Authority

PRO-RATA/PROPORTIONAL
Reinsurance or insurance where the reinsurer or insurer shares a proportional part of the original premiums and losses of the reinsured or insured

QST
Quota Share Treaty

RDS
Realistic Disaster Scenarios

RETROCESSION
The reinsurance of a reinsurance account

RMS
Risk Management Solutions

RPI
Renewal Price Index

RRC
Risk and Return Committee

RROC
Regulatory Reporting Oversight Committee

RSC
Reinsurance Security Committee

RSS
Restricted share scheme

SCR
Solvency Capital Requirement

SHARP
Lancashire's in house aggregation system

TOTAL SHAREHOLDER RETURN (TSR)
The IRR of the increase/ (decrease) in share price in the period, measured in U.S. dollars, adjusted for dividends

TREATY REINSURANCE
A reinsurance contract under which the reinsurer agrees to offer and to accept all risks of a certain size within a defined class

UK
United Kingdom

UMCC
Underwriting and Marketing Conference Call

UNEARNED PREMIUMS (UPR)
The portion of premium income that is attributable to periods after the balance sheet date that is deferred and amortised to future accounting periods

VALUE AT RISK (VAR)
A measure of the risk of loss of a specific portfolio of financial assets