LANCASHIRE HOLDINGS LIMITED

GROWTH IN FULLY CONVERTED BOOK VALUE PER SHARE, ADJUSTED FOR DIVIDENDS OF 3.1% IN Q4 2012, 16.7% IN 2012
COMBINED RATIO OF 71.9% IN Q4 2012, 63.9% FOR 2012
SPECIAL DIVIDEND OF $1.05 PER COMMON SHARE
FINAL ORDINARY DIVIDEND OF $0.10 PER COMMON SHARE
FULLY CONVERTED BOOK VALUE PER SHARE OF $7.83 AT 31 DECEMBER 2012

21 February 2013
Hamilton, Bermuda

Lancashire Holdings Limited ("Lancashire" or "the Group") today announces its results for the fourth quarter of 2012 and the year ended 31 December 2012.

Financial highlights:

	As at 31 December 2012	As at 31 December 2011
Fully converted book value per share	**$7.83**	**$7.62**
Return on equity* – Q4	**3.1%**	**2.7%**
Return on equity* – Year	**16.7%**	**13.4%**
Operating return on average equity – Q4	**2.8%**	**2.6%**
Operating return on average equity – Year	**15.3%**	**15.8%**
Special dividend per common share**	**$1.95**	**$0.80**

* Return on equity is defined as growth in fully converted book value per share, adjusted for dividends.
** Figure represents the total special dividends declared for the year ended 31 December and includes any other special dividends previously declared in relation to the year ended 31 December - See "Dividends" below for further details.

	Three months ended		Year ended	
	31 Dec 2012	**31 Dec 2011**	**31 Dec 2012**	**31 Dec 2011**
Highlights ($m)				
Gross premiums written	96.0	109.6	724.3	632.3
Net premiums written	100.7	102.4	576.1	565.1
Profit before tax	51.7	40.2	236.8	218.6
Profit after tax	52.4	39.0	234.9	212.2
Comprehensive income	48.4	39.8	252.7	201.6
Net operating profit	43.6	38.1	220.3	219.0
Per share data				
Diluted earnings per share	$0.28	$0.22	$1.29	$1.20
Diluted earnings per share – operating	$0.23	$0.21	$1.21	$1.23
Financial ratios				
Total investment return	0.3%	0.6%	3.1%	1.8%
Net loss ratio	41.3%	39.4%	29.9%	31.7%
Combined ratio	71.9%	73.1%	63.9%	63.7%
Accident year loss ratio	30.9%	65.0%	34.6%	59.3%

Richard Brindle, Group Chief Executive Officer, commented:

I am pleased to report a solid final quarter and an excellent year for Lancashire. Our RoE of 16.7% for the year represents a strong result. Lancashire has now increased book value per share, including dividends, every year since its inception in 2005 and has achieved an industry beating compound annual return over that period of 19.2%.

The exceptional level of market losses witnessed in 2011 was not repeated in 2012. There were nonetheless material industry losses, including the loss of the Costa Concordia, which in addition to causing tragic loss of life was also the largest insured marine loss in history, and the devastation and injury of Sandy during the fourth quarter, which is likely to be one of the largest insured property losses of all time.

At the beginning of 2012 I expressed a cautious optimism about the insurance pricing environment. That proved justified in our property retrocession and reinsurance lines and in the energy offshore accounts. Otherwise, the rating environment, outside of loss affected accounts in our core lines, remained competitive. On our direct property business, rates, and more importantly terms and conditions, proved frustratingly immune to improvement. Coupled with the cost of capital and reinsurance costs, this led to the hard decision to cease underwriting our direct and facultative book in the summer of 2012.

In recent years we have developed our business by engaging with third party capital providers through both the Accordion and the Saltire facilities. We see such opportunities as a capital-efficient way of generating additional benefits for our shareholders, drawing on Lancashire's underwriting expertise. We are actively engaged in the further development of these types of opportunities under the banner of "Lancashire Capital Management". We are careful only to develop products we believe in and to ensure that these projects don't distract us from the "mothership".

Our success is built on the talent and quality of our people. We have worked hard in 2012 to bring our different disciplines even closer together. In Bermuda our underwriting and actuarial teams now operate in a fully integrated way to assess and price risk. Our fortnightly Risk and Return Committee meeting brings together senior people from underwriting, finance, actuarial, risk and operations to look at all areas of our company. This teamwork drives our success, and I would like to thank all our staff for their commitment and contribution to another excellent year.

Elaine Whelan, Group Chief Financial Officer, commented:

With our best estimate of our net loss from Sandy at $44.5 million, after reinsurance and reinstatement premium, we produced a strong underwriting result for the fourth quarter with a combined ratio of 71.9%. In the face of continuing uncertainty and volatility in the investment markets, our portfolio held up well, producing a positive total return for the quarter of 0.3%. That brought us to a very satisfactory 3.1% total return for the year. I am therefore delighted to report a healthy RoE for the quarter of 3.1% and for the year of 16.7%.

We enhanced our capital mix by issuing $130 million of ten year unsecured senior debt early in the fourth quarter. While we sought opportunities to put this to work at the 1 January renewals, we have significant excess headroom as markets look broadly flat following the Sandy loss. We are therefore returning a substantial amount of capital in the first quarter. With today's announcement of our final and special dividends, plus the related dividend equivalent payments, totalling approximately $220 million, we will have returned $1.7 billion or 93.7% of our comprehensive income since inception.

While we remain very well capitalised, to ensure we're prepared for any eventuality, we will again request shareholder approval for a renewed authority to allot and issue share capital on a non pre-emptive basis at our Annual General Meeting in May.

Lancashire Renewal Price Index for major classes

Lancashire's Renewal Price Index ("RPI") is an internal methodology that management uses to track trends in premium rates on a portfolio of insurance and reinsurance contracts. The RPI is calculated on a per contract basis and reflects Lancashire's assessment of relative changes in price, terms, conditions and limits on like for like renewals only, and is weighted by premium volume (see "Note Regarding RPI methodology" at the end of this announcement for further guidance). The RPI does not include new business. The following RPIs are expressed as an approximate percentage of pricing achieved on similar contracts written in 2011:

Class	Year 2012	Q4 2012	Q3 2012	Q2 2012	Q1 2012
Aviation (AV52)	93%	90%	96%	98%	92%
Gulf of Mexico energy	100%	101%	103%	100%	100%
Energy offshore worldwide	103%	100%	104%	104%	102%
Marine	108%	102%	100%	130%	103%
Property retrocession and reinsurance	120%	97%	104%	145%	112%
Terrorism	97%	94%	99%	98%	96%
Combined	**104%**	**96%**	**101%**	**109%**	**103%**

Underwriting results

Gross premiums written

	Q4				Year			
	2012 $m	2011 $m	Change $m	Change %	2012 $m	2011 $m	Change $m	Change %
Property	33.6	49.7	(16.1)	(32.4)	356.5	279.8	76.7	27.4
Energy	25.3	23.2	2.1	9.1	240.9	229.0	11.9	5.2
Marine	15.4	18.6	(3.2)	(17.2)	81.0	76.4	4.6	6.0
Aviation	21.7	18.1	3.6	19.9	45.9	47.1	(1.2)	(2.5)
Total	**96.0**	**109.6**	**(13.6)**	**(12.4)**	**724.3**	**632.3**	**92.0**	**14.6**

Gross premiums written decreased by 12.4% in the fourth quarter of 2012 compared to the fourth quarter of 2011. In 2012 annual gross premiums written increased by 14.6% over 2011. The Group's four principal classes, and the key market factors impacting them, are discussed below.

Property gross premiums written decreased by 32.4% for the fourth quarter of 2012 compared to the same period in 2011 and increased by 27.4% for the year ended 31 December 2012 compared to the year ended 31 December 2011. The decrease in property premiums in the fourth quarter of 2012 compared to the same period in 2011 is primarily due to the decision to cease writing property direct and facultative business from 1 July 2012 as a result of continued poor trading conditions and concerns about the breadth of coverage in that business line. Property catastrophe and retrocession premiums also showed a small reduction on the prior year as opportunistic deals written in the fourth quarter of 2011, following the accumulation of international catastrophe events that year, were not renewed. For the year, the increase in property premiums was largely due to increased property retrocession writings at 1 January 2012. We significantly increased our property retrocession exposure at 1 January 2012 in anticipation of a declining trading environment over the rest of the year. We utilised the Accordion sidecar for a sizeable portion of that business, with further cessions to the vehicle at 1 April 2012 and 1 July 2012. 2012 property catastrophe excess-of-loss premiums were also higher than the prior year. Within this class we replaced one significant contract, plus some 2011 back-up deals, with better priced new business, largely on loss affected contracts. 2012 has also seen an increase in premium written in the political and sovereign risk classes compared to 2011. These markets tend to be more unpredictable than other classes of business and there is a limited amount of renewal business as policies often relate to specific one-off projects. Offsetting these year on year increases, premium volumes were lower for our property direct and facultative book throughout the year as we reduced our appetite prior to our formal exit from that business line on 1 July 2012.

Energy gross premiums written increased in the fourth quarter of 2012 by 9.1% compared to the same period in 2011 and increased by 5.2% for the year ended 31 December 2012 compared to the year ended 31 December 2011. The actual dollar value of the increase in the fourth quarter was negligible and premium volumes were relatively consistent across all energy classes compared to the same quarter of 2011. The increase in premiums year on year was driven primarily by new business plus premium flow from prior year risks attaching in the offshore worldwide book. In 2011 many of the Gulf of Mexico book deals were written on a multi-year basis and are not up for renewal. However, that premium volume was almost entirely replaced by new premium from prior underwriting year multi-year contracts that renewed ahead of their expiration, as clients sought to lock-in wind cover beyond the original term. We also saw some new business in the energy construction class written throughout 2012, mostly on a multi-year basis.

Marine gross premiums written decreased by 17.2% for the fourth quarter of 2012 compared to the same period in 2011 and increased by 6.0% for the year ended 31 December 2012 compared to the year ended 31 December 2011. The small decrease in fourth quarter premium volumes in 2012 compared to 2011 was largely due to the timing of risks attaching on multi-year builders risk contracts, offset somewhat by the timing of non annual contract renewals in marine hull. The full-year increase was largely driven by the timing of multi-year contract renewals, which included significant price increases on loss affected contracts following the Costa Concordia marine loss in the first quarter of 2012.

Aviation gross premiums written increased by 19.9% for the fourth quarter of 2012 compared to the same period in 2011 and decreased by 2.5% for the year ended 31 December 2012 compared to the year ended 31 December 2011. While pricing and renewal rates remain under some pressure, the AV52 class renewed at similar volumes to the same period in 2011. We also saw good deal flow on the satellite class, which we re-entered in the third quarter of 2012.

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Ceded reinsurance premiums decreased by $11.9 million, or 165.3% for the fourth quarter of 2012 compared to the fourth quarter of 2011 and increased by $81.0 million, or 120.5%, for the year ended 31 December 2012 compared to the year ended 31 December 2011. The quarterly movement was driven almost entirely by movements in the Thailand flood losses. The fourth quarter of 2011 included a reinstatement premium charge, while the fourth quarter of 2012 saw a reduction in this as the losses continue to be adjusted. Cessions to the Accordion sidecar were $64.8 million for the year versus $12.2 million for 2011. In 2012 we also opportunistically purchased more Industry Loss Warranties, amongst other reinsurance programs, and expanded our marine and energy cover following the Costa Concordia loss in the first quarter of 2012.

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Net premiums earned as a proportion of net premiums written were 146.1% in the fourth quarter of 2012 compared to 135.0% in the same period in 2011 and 101.1% for the year ended 31 December 2012 compared to 101.7% for the year ended 31 December 2011.

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The Group’s net loss ratio for the fourth quarter of 2012 was 41.3% compared to 39.4% for the same period in 2011 and 29.9% for the year ended 31 December 2012 compared to 31.7% for the year ended 31 December 2011.

The twelve months to 31 December 2012 include a total estimated net loss of $59.2 million, after reinsurance and reinstatement premiums, in relation to the total loss of the Costa Concordia, and $44.5 million in relation to Sandy. This compares to specific event net losses, after reinsurance and reinstatement premiums, of $138.5 million in the twelve months to 31 December 2011 in relation to the Tohoku and Christchurch Lyttleton earthquakes and $25.1 million for the Thailand flood losses.

Prior year adverse development for the fourth quarter of 2012 was $15.1 million, compared to favourable development of $37.3 million for the fourth quarter of 2011. The fourth quarter of 2012 included adverse development for the Thailand floods of $19.4 million following updated reports from the loss adjusters. After reinstatement premiums and foreign exchange movements, net adverse development for the Group was $11.4 million in the fourth quarter of 2012. In the fourth quarter of 2011 we received further information on outstanding case reserves which resulted in reserve releases. Both periods otherwise benefited from prior year IBNR releases.

Favourable development was $27.4 million for the twelve months to 31 December 2012, compared to $155.3 million for the same period in 2011. In early 2011 an independent external reserve study was commissioned in order to incorporate the Group's own loss experience with industry factors previously used. On completion, net reserves of $36.9 million were released. Both years otherwise experienced releases due to lower than expected prior year reported losses, with the 2011 financial year also seeing a number of medium sized claims closing in our favour.

The following tables show the impact of prior year development and notable current year losses on the Group's loss ratio, both individually and on a combined basis:

	Q4 2012		**Year 2012**	
	Losses $m	**Loss Ratio %**	**Losses $m**	**Loss Ratio %**
At 31 December 2012	60.7	41.3	174.1	29.9
Absent Costa Concordia	60.7	41.3	128.3	21.5
Absent Sandy	14.7	10.1	128.1	22.0
Absent prior year development	45.6	31.0	201.5	34.6
Adjusted losses and ratio	**(0.4)**	**(0.3)**	**109.7**	**18.7**

Note: Adjusted loss ratio excludes large losses and prior year development. The table does not sum to a total due to the impact of reinstatement premiums.

The prior year development includes adverse development after reinsurance of $23.1 million for the year and $19.4 million for the fourth quarter in relation to the Thailand floods loss. Absent this loss, the net loss ratios would have been 26.3% for 2012 and 28.7% for the fourth quarter.

	Q4 2011		**Year 2011**	
	Losses $m	**Loss Ratio %**	**Losses $m**	**Loss Ratio %**
At 31 December 2011	54.4	39.4	182.3	31.7
Absent Tohoku & Christchurch	11.4	8.3	37.5	6.6
Absent Gryphon FPSO	54.4	39.3	134.2	23.2
Absent Thailand floods	35.3	24.5	163.2	28.1
Absent prior year development	91.7	66.4	337.6	58.8
Adjusted losses and ratio	**29.6**	**20.6**	**125.6**	**21.7**

Note: Adjusted loss ratio excludes large losses plus prior year development. The table does not sum to a total due to the impact of reinstatement premiums.

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

	Q4		Year	
	2012	2011	2012	2011
	$m	$m	$m	$m
Property	(25.7)	23.3	(36.0)	63.5
Energy	7.6	10.3	37.4	57.3
Marine	3.0	3.4	25.9	28.6
Aviation	-	0.3	0.1	5.9
Total	**(15.1)**	**37.3**	**27.4**	**155.3**

Note: Positive numbers denote favourable development.

The accident year loss ratio for the fourth quarter of 2012, including the impact of foreign exchange revaluations, was 30.9% compared to 65.0% for the same period in 2011. The accident year loss ratio for the year ended 31 December 2012 was 34.6% compared to 59.3% for the year ended 31 December 2011.

The accident year loss ratio for the year ended 31 December 2012 included:

- 8.5% for the Costa Concordia loss; and
- 7.8% for Sandy.

The accident year loss ratio for the year ended 31 December 2011 included:

- 20.6% for the Tohoku earthquake;
- 8.7% for the Gryphon FPSO loss;
- 4.0% for the Christchurch Lyttleton earthquake; and
- 3.9% for the Thailand floods.

Otherwise, both years experienced relatively low levels of reported losses.

Excluding the impact of foreign exchange revaluations, previous accident years' ultimate losses developed as follows during 2012 and 2011:

	Year ended 31 Dec 2012	Year ended 31 Dec 2011
	$m	$m
2006 accident year	0.4	2.9
2007 accident year	2.3	11.1
2008 accident year	1.7	29.8
2009 accident year	7.1	33.7
2010 accident year	6.4	77.8
2011 accident year	9.5	-
Total	**27.4**	**155.3**

Note: Positive numbers denote favourable development.

The ratio of IBNR to total net loss reserves was 28.1% at 31 December 2012 compared to 33.5% at 31 December 2011.

Investments

Net investment income, excluding realised and unrealised gains and losses, was $8.0 million for the fourth quarter of 2012, a decrease of 10.1% from the fourth quarter of 2011. Net investment income was $32.5 million for the year ended 31 December 2012, compared to $43.2 million for the prior year. Overall lower yields and a reduction in the growth market portfolio contributed to the decrease in investment income for the fourth quarter of 2012 and the year ended 31 December 2012 compared to the same periods in 2011.

As at 31 December 2012 4.5% of the portfolio was allocated to the growth market debt portfolio with an overall average credit quality of BBB. The corporate bond allocation, excluding Federal Deposit Insurance Corporation guaranteed bonds, represented 32.2% of managed invested assets at 31 December 2012 compared to 29.9% at 31 December 2011. During the fourth quarter of 2012 the Group increased its allocation to bank loans to 1.8% of the portfolio. The allocation to bank loans is part of our interest rate risk management strategy and will ultimately be approximately 3.5% of the total managed assets when fully funded.

Total investment return, including net investment income, net realised gains and losses, impairments and net change in unrealised gains and losses, was $7.1 million for the fourth quarter of 2012 compared to $12.7 million for the fourth quarter of 2011, and was $62.8 million for the year ended 31 December 2012 versus $40.7 million for the year ended 31 December 2011. Credit spreads tightened significantly across the portfolio for the twelve months to 31 December 2012.

The managed portfolio was invested as follows:

	As at 31 December 2012	**As at 31 December 2011**
Fixed income securities	88.9%	86.8%
Cash and cash equivalents	11.1%	13.2%
Total	**100.0%**	**100.0%**

Key investment portfolio statistics were:

	As at 31 December 2012	**As at 31 December 2011**
Duration	1.8 years	1.8 years
Credit quality	AA-	AA-
Book yield	1.8%	1.9%
Market yield	1.1%	1.5%

Accordion

The share of profit of associate of $3.3 million for the fourth quarter of 2012 and the share of profit of associate of $7.7 million for the year ended 31 December 2012 reflected Lancashire's 20% equity interest in the vehicle. Our share of profit of associate was $0.9 million for the year ended 31 December 2011.

Other operating expenses

Operating expenses consist of the following items:

	Q4		**Year**	
	2012 $m	**2011 $m**	**2012 $m**	**2011 $m**
Employee remuneration	8.6	9.8	46.9	40.8
Other operating expenses	7.3	4.9	31.5	30.2
Total	**15.9**	**14.7**	**78.4**	**71.0**

In the first quarter of 2012 employee remuneration included a one-off national insurance charge of $6.9 million, incurred as a result of the Group's tax residency move to the UK effective from 1 January 2012. In the fourth quarter of 2012 the Group incurred certain legal fees in relation to its October 2012 $130 million senior debt issuance. Conversely, the fourth quarter of 2011 saw a reduction in other operating expenses due to a recovery on lease costs.

Equity based compensation was $3.9 million in the fourth quarter of 2012 compared to $6.2 million in the same period of 2011. For the years ended 31 December 2012 and 2011 the charge was $16.4 million and $18.8 million respectively. The equity compensation charge in the fourth quarter of 2011 and for the year ended 31 December 2011 included $0.7 million and $4.2 million, respectively, in relation to dividend strike price revisions on option awards under the Group's 2005 Long Term Incentive Plan Option Scheme. This was closed to further awards in 2008. By the first quarter of 2012 the majority of these previously issued option awards had been exercised and the remaining charges on them were negligible.

Capital

At 31 December 2012, total capital for the Group was $1.646 billion, comprising shareholders' equity of $1.387 billion and $258.7 million of long-term debt. Leverage was 15.7% of total capital. The Group's total capital at 31 December 2011 was $1.455 billion.

On 5 October the Group launched and priced an offering of U.S. $130 million 5.70% senior unsecured notes due 2022 (the "Notes") pursuant to a private offering to U.S. Qualified Institutional Buyers and to other eligible purchasers outside of the U.S. The Notes were listed and admitted to trading on the London Stock Exchange on 16 October 2012.

Dividends

The Lancashire Board declared the following dividends during 2012:

- A final dividend in respect of 2011 of $0.10 per common share;
- An interim dividend of $0.05 per common share; and
- A special dividend of $0.90 per common share.

Lancashire announces that its Board has declared the following dividend payments (collectively the "Dividends"):

> (i) a final dividend for 2012 of $0.10 per common share (approximately £0.06 per common share at the current exchange rate) amounting to an aggregate payment of approximately $16.1 million; and
>
> (ii) an additional special dividend for 2012 of $1.05 per common share (approximately £0.68 per common share at the current exchange rate) amounting to an aggregate payment of approximately $169.6 million.

The Dividends will result in an aggregate payment of approximately $185.7 million. The Dividends will be paid as a single payment in Pounds Sterling on 17 April 2013 (the "Dividend Payment Date") to shareholders of record on 22 March 2013 (the "Record Date") using the £/$ spot market exchange rate at 12 noon London time on the Record Date.

Shareholders interested in participating in the dividend reinvestment plan ("DRIP") or other services including international payment, are encouraged to contact the Group registrars, Capita Registrars for more details at: http://www.capitaregistrars.com/shareholder.aspx

In addition to the payment of the Dividends to shareholders, a dividend equivalent payment of $3.0 million in respect the final dividend and $31.3 million in respect of the additional special dividend for an aggregate amount of approximately $34.3 million will be paid on the Dividend

Payment Date to holders of share warrants issued by Lancashire pursuant to the terms of the warrants.

The Group will continue to review the appropriate level and composition of capital for the Group with the intention of managing capital to enhance risk-adjusted returns on equity.

Financial information

The consolidated financial statements set out below are audited. The audited Annual Report and Accounts are expected to be posted to shareholders no later than 20 March 2013 and will also be made available on the Group website.

Further details of our 2012 fourth quarter results can be obtained from our Financial Supplement. This can be accessed via our website at www.lancashiregroup.com.

Analyst and Investor Earnings Conference Call

There will be an analyst and investor conference call on the results at 1:00pm UK time/8:00am EST on Thursday 21 February 2013. The conference call will be hosted by Lancashire management.

The call can be accessed by dialling +44 0208 817 9301/+1 718 354 1226 with the confirmation code 9703508. The call can also be accessed via webcast, please go to our website (www.lancashiregroup.com) to access.

A replay facility will be available for two weeks until Thursday 7 March 2013. The dial in number for the replay facility is +44 0207 769 6425 with passcode 9703508# .The replay facility will also be accessible at www.lancashiregroup.com

For further information, please contact:

Lancashire Holdings Limited

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Investor enquiries and questions can also be directed to info@lancashiregroup.com or by accessing the Group's website at: www.lancashiregroup.com.

About Lancashire

Lancashire, through its UK and Bermuda-based operating subsidiaries, is a global provider of specialty insurance and reinsurance products. The Group companies carry the following ratings:

	Financial Strength Rating (1)	**Long Term Issuer Rating** (2)	**Outlook**
A.M. Best	A	bbb	Stable
Standard & Poor's	A-	BBB	Stable
Moody's	A3	Baa2	Stable

(1)Financial Strength Rating applies to Lancashire Insurance Company Limited and Lancashire Insurance Company (UK) Limited

(2) Long Term Issuer Rating applies to Lancashire Holdings Limited

Lancashire has capital in excess of $1 billion and its common shares trade on the Main Market of the London Stock Exchange under the ticker symbol LRE. Lancashire has its corporate headquarters and mailing address at Level 11, Vitro, 60 Fenchurch Street, London EC3M 4AD, United Kingdom and its registered office at Power House, 7 Par-la-Ville Road, Hamilton HM 11, Bermuda.

For more information on Lancashire, visit the Group website at www.lancashiregroup.com

Lancashire Insurance Company Limited is regulated by the Bermuda Monetary Authority in Bermuda.

Lancashire Insurance Company (UK) Limited is regulated by the Financial Services Authority in the UK.

NOTE REGARDING RPI METHODOLOGY

LANCASHIRE'S RENEWAL PRICE INDEX ("RPI") IS AN INTERNAL METHODOLOGY THAT ITS MANAGEMENT USES TO TRACK TRENDS IN PREMIUM RATES OF A PORTFOLIO OF INSURANCE AND REINSURANCE CONTRACTS. THE RPI IS CALCULATED ON A PER CONTRACT BASIS AND REFLECTS LANCASHIRE'S ASSESSMENT OF RELATIVE CHANGES IN PRICE, TERMS, CONDITIONS AND LIMITS AND IS WEIGHTED BY PREMIUM VOLUME. THE CALCULATION INVOLVES A DEGREE OF JUDGEMENT IN RELATION TO COMPARABILITY OF CONTRACTS AND THE ASSESSMENT NOTED ABOVE. TO ENHANCE THE RPI METHODOLOGY, MANAGEMENT OF LANCASHIRE MAY REVISE THE METHODOLOGY AND ASSUMPTIONS UNDERLYING THE RPI, SO THE TRENDS IN PREMIUM RATES REFLECTED IN THE RPI MAY NOT BE COMPARABLE OVER TIME. CONSIDERATION IS ONLY GIVEN TO RENEWALS OF A COMPARABLE NATURE SO IT DOES NOT REFLECT EVERY CONTRACT IN LANCASHIRE'S PORTFOLIO. THE FUTURE PROFITABILITY OF THE PORTFOLIO OF CONTRACTS WITHIN THE RPI IS DEPENDENT UPON MANY FACTORS BESIDES THE TRENDS IN PREMIUM RATES.

NOTE REGARDING FORWARD-LOOKING STATEMENTS:

CERTAIN STATEMENTS AND INDICATIVE PROJECTIONS (WHICH MAY INCLUDE MODELED LOSS SCENARIOS) MADE IN THIS RELEASE OR OTHERWISE THAT ARE NOT BASED ON CURRENT OR HISTORICAL FACTS ARE FORWARD-LOOKING IN NATURE, INCLUDING, WITHOUT LIMITATION, STATEMENTS CONTAINING THE WORDS 'BELIEVES', 'ANTICIPATES', 'PLANS', 'PROJECTS', 'FORECASTS', 'GUIDANCE', 'INTENDS', 'EXPECTS', 'ESTIMATES', 'PREDICTS', 'MAY', 'CAN', 'WILL', 'SEEKS', 'SHOULD', OR, IN EACH CASE, THEIR NEGATIVE OR COMPARABLE TERMINOLOGY. ALL STATEMENTS OTHER THAN STATEMENTS OF HISTORICAL FACTS INCLUDING, WITHOUT LIMITATION, THOSE REGARDING THE TAX RESIDENCY OF THE COMPANY AND ITS SUBSIDIARIES (THE "GROUP"), ITS FINANCIAL POSITION, RESULTS OF OPERATIONS, LIQUIDITY, PROSPECTS, GROWTH, CAPITAL MANAGEMENT PLANS, BUSINESS STRATEGY, PLANS AND OBJECTIVES OF MANAGEMENT FOR FUTURE OPERATIONS (INCLUDING DEVELOPMENT PLANS AND OBJECTIVES RELATING TO THE GROUP'S INSURANCE BUSINESS) ARE FORWARD-LOOKING STATEMENTS. SUCH FORWARD-LOOKING STATEMENTS INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER IMPORTANT FACTORS THAT COULD CAUSE THE ACTUAL RESULTS, PERFORMANCE OR ACHIEVEMENTS OF THE GROUP TO BE MATERIALLY DIFFERENT FROM FUTURE RESULTS, PERFORMANCE OR ACHIEVEMENTS EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS.

THESE FACTORS INCLUDE, BUT ARE NOT LIMITED TO: THE NUMBER AND TYPE OF INSURANCE AND REINSURANCE CONTRACTS THAT THE GROUP WRITES; THE PREMIUM RATES AVAILABLE AT THE TIME OF SUCH RENEWALS WITHIN THE GROUP'S TARGETED BUSINESS LINES; THE LOW FREQUENCY OF LARGE EVENTS; UNUSUAL LOSS FREQUENCY; THE IMPACT THAT THE GROUP'S FUTURE OPERATING RESULTS, CAPITAL POSITION AND RATING AGENCY AND OTHER CONSIDERATIONS HAVE ON THE EXECUTION OF ANY CAPITAL MANAGEMENT INITIATIVES; THE POSSIBILITY OF GREATER FREQUENCY OR SEVERITY OF CLAIMS AND LOSS ACTIVITY THAN THE GROUP'S UNDERWRITING, RESERVING OR INVESTMENT PRACTICES HAVE ANTICIPATED; THE RELIABILITY OF, AND CHANGES IN ASSUMPTIONS TO, CATASTROPHE PRICING, ACCUMULATION AND ESTIMATED LOSS MODELS; THE EFFECTIVENESS OF THE GROUP'S LOSS LIMITATION METHODS; LOSS OF KEY PERSONNEL; A DECLINE IN THE GROUP'S OPERATING SUBSIDIARIES' RATING WITH A.M. BEST, STANDARD & POOR'S, MOODY'S OR OTHER RATING AGENCIES; INCREASED COMPETITION ON THE BASIS OF PRICING, CAPACITY, COVERAGE TERMS OR OTHER FACTORS; A CYCLICAL DOWNTURN OF THE INDUSTRY; THE IMPACT OF A DETERIORATING CREDIT ENVIRONMENT FOR ISSUERS OF FIXED INCOME INVESTMENTS; THE IMPACT OF SWINGS IN MARKET INTEREST RATES AND SECURITIES PRICES; A RATING DOWNGRADE OF, OR A MARKET DECLINE IN, SECURITIES IN THE GROUP'S INVESTMENT PORTFOLIO; CHANGES IN GOVERNMENTAL REGULATIONS OR TAX LAWS IN JURISDICTIONS WHERE THE GROUP CONDUCTS BUSINESS; LANCASHIRE HOLDINGS LIMITED OR ITS BERMUDIAN SUBSIDIARY BECOMING SUBJECT TO INCOME TAXES IN THE UNITED STATES OR THE BERMUDIAN SUBSIDIARY BECOMING SUBJECT TO INCOME TAXES IN THE UNITED KINGDOM; THE UK TEMPORARY PERIOD EXEMPTION UNDER THE CFC REGIME FAILING TO REMAIN IN FORCE FOR THE PERIOD INTENDED; THE INAPPLICABILITY TO THE GROUP OF SUITABLE EXCLUSIONS FROM THE NEW UK CFC REGIME; ANY CHANGE IN THE UK GOVERNMENT OR THE UK GOVERNMENT POLICY WHICH IMPACTS THE NEW CFC REGIME; AND THE NEGATIVE IMPACT IN ANY MATERIAL WAY OF THE CHANGE IN TAX RESIDENCE OF LANCASHIRE HOLDINGS LIMITED ON ITS STAKEHOLDERS.

THESE FORWARD-LOOKING STATEMENTS SPEAK ONLY AS AT THE DATE OF PUBLICATION. LANCASHIRE EXPRESSLY DISCLAIMS ANY OBLIGATION OR UNDERTAKING (SAVE AS REQUIRED TO COMPLY WITH ANY LEGAL OR REGULATORY OBLIGATIONS (INCLUDING THE RULES OF THE LONDON STOCK EXCHANGE)) TO DISSEMINATE ANY UPDATES OR REVISIONS TO ANY FORWARD-LOOKING STATEMENTS TO REFLECT ANY CHANGES IN THE GROUP'S EXPECTATIONS OR CIRCUMSTANCES ON WHICH ANY SUCH STATEMENT IS BASED.

Consolidated statement of comprehensive income
For the year ended 31 December 2012

	Notes	2012 $m	2011 $m
Gross premiums written	2	724.3	632.3
Outwards reinsurance premiums	2	(148.2)	(67.2)
Net premiums written		**576.1**	**565.1**
Change in unearned premiums	2	3.8	3.5
Change in unearned premiums on premiums ceded	2	2.7	5.9
Net premiums earned		**582.6**	**574.5**
Net investment income	3	32.5	43.2
Net other investment income (losses)	3	0.7	(0.5)
Net realised gains (losses) and impairments	3	11.8	8.6
Share of profit of associates	16	7.7	0.9
Net foreign exchange gains (losses)		4.3	(9.4)
Total net revenue		**639.6**	**617.3**
Insurance losses and loss adjustment expenses	2, 12	216.9	225.3
Insurance losses and loss adjustment expenses recoverable	2, 12	(42.8)	(43.0)
Net insurance losses		**174.1**	**182.3**
Insurance acquisition expenses	2, 4	130.2	114.2
Insurance acquisition expenses ceded	2, 4	(10.8)	(1.8)
Other operating expenses	5, 6, 23	78.4	71.0
Equity based compensation	6	16.4	18.8
Total expenses		**388.3**	**384.5**
Results of operating activities		**251.3**	**232.8**
Financing costs	7	14.5	14.2
Profit before tax		**236.8**	**218.6**
Tax charge	8	1.9	6.4
Profit for the year attributable to equity shareholders		**234.9**	**212.2**
Net change in unrealised gains/losses on investments	3, 10	18.1	(10.5)
Tax provision on net change in unrealised gains/losses on investments	10	(0.3)	(0.1)
Other comprehensive income (loss)	10	**17.8**	**(10.6)**
Total comprehensive income attributable to equity shareholders		**252.7**	**201.6**
Earnings per share			
Basic	24	$1.47	$1.38
Diluted	24	$1.29	$1.20

Consolidated balance sheet
As at 31 December 2012

	Notes	2012 $m	2011 $m
Assets			
Cash and cash equivalents	9, 20	295.8	311.8
Accrued interest receivable		9.3	10.0
Investments			
– Fixed income securities	10, 20	1,874.5	1,714.0
– Other investments	10	0.1	(0.6)
Reinsurance assets			
– Unearned premiums on premiums ceded	11	11.5	8.8
– Reinsurance recoveries	12	73.0	69.7
– Other receivables	11	4.5	6.2
Deferred acquisition costs	14	68.0	61.4
Other receivables		2.7	48.6
Inwards premiums receivable from insureds and cedants	13	207.0	212.1
Deferred tax asset	15	7.3	8.2
Corporation tax receivable		0.4	–
Investment in associates	16	82.1	50.9
Property, plant and equipment	17	2.8	5.3
Intangible asset		–	1.2
Total assets		**2,639.0**	**2,507.6**
Liabilities			
Insurance contracts			
– Losses and loss adjustment expenses	12	537.4	571.2
– Unearned premiums	18	343.3	347.1
– Other payables	18, 19	23.5	23.5
Amounts payable to reinsurers	11, 19	30.6	17.8
Deferred acquisition costs ceded	14	0.8	0.7
Other payables	19	49.3	85.2
Corporation tax payable		–	1.2
Interest rate swap	20	8.0	6.1
Long-term debt	20	258.7	128.0
Total liabilities		**1,251.6**	**1,180.8**
Shareholders' equity			
Share capital	21	84.3	84.3
Own shares	21	(57.1)	(83.0)
Share premium		2.4	2.4
Contributed surplus		654.4	660.5
Accumulated other comprehensive income	10	35.4	17.6
Other reserves	22	57.1	67.6
Retained earnings		610.9	577.4
Total shareholders' equity attributable to equity shareholders		**1,387.4**	**1,326.8**
Total liabilities and shareholders' equity		**2,639.0**	**2,507.6**

The consolidated financial statements were approved by the Board of Directors on 20 February 2013 and signed on its behalf by:

Martin Thomas
Director/Chairman

Elaine Whelan
Director/CFO

Consolidated statement of changes in shareholders' equity
For the year ended 31 December 2012

	Notes	Share capital $m	Own shares $m	Share premium $m	Contributed surplus $m	Accumulated other compre-hensive income $m	Other reserves $m	Retained earnings $m	Total $m
Balance as at 31 December 2010		**84.3**	**(106.9)**	**2.4**	**662.6**	**28.2**	**70.7**	**545.6**	**1,286.9**
Total comprehensive income for the year	10	–	–	–	–	(10.6)	–	212.2	201.6
Distributed by trust	21	–	33.7	–	(38.2)	–	–	–	(4.5)
Shares donated to trust	21, 25	–	(15.4)	–	15.4	–	–	–	–
Dividends on common shares	21	–	–	–	–	–	–	(147.7)	(147.7)
Dividend equivalents on warrants	21	–	–	–	–	–	–	(32.7)	(32.7)
Warrant exercises – founder	21	–	5.6	–	(1.1)	–	(4.5)	–	–
Equity based compensation – tax	8	–	–	–	–	–	4.4	–	4.4
Equity based compensation – exercises	6, 21, 22	–	–	–	21.8	–	(21.8)	–	–
Equity based compensation – expense	6	–	–	–	–	–	18.8	–	18.8
Balance as at 31 December 2011		**84.3**	**(83.0)**	**2.4**	**660.5**	**17.6**	**67.6**	**577.4**	**1,326.8**
Total comprehensive income for the year	10	–	–	–	–	17.8	–	234.9	252.7
Distributed by trust	21	–	33.2	–	(41.9)	–	–	–	(8.7)
Shares donated to trust	21, 25	–	(18.4)	–	18.4	–	–	–	–
Dividends on common shares	21	–	–	–	–	–	–	(168.6)	(168.6)
Dividend equivalents on warrants	21	–	–	–	–	–	–	(32.8)	(32.8)
Warrant exercises – founder	21	–	11.1	–	(3.4)	–	(7.7)	–	–
Equity based compensation – tax	8	–	–	–	–	–	1.6	–	1.6
Equity based compensation – exercises	6, 21, 22	–	–	–	20.8	–	(20.8)	–	–
Equity based compensation – expense	6	–	–	–	–	–	16.4	–	16.4
Balance as at 31 December 2012		**84.3**	**(57.1)**	**2.4**	**654.4**	**35.4**	**57.1**	**610.9**	**1,387.4**

Financial statements

Statement of consolidated cash flows
For the year ended 31 December 2012

	Notes	2012 $m	2011 $m
Cash flows from operating activities			
Profit before tax		236.8	218.6
Tax paid		(1.2)	(9.7)
Depreciation	5	2.8	2.9
Interest expense on long-term debt	7	7.2	5.6
Interest and dividend income		(48.4)	(56.2)
Net amortisation of fixed income securities		11.8	8.7
Equity based compensation	6	16.4	18.8
Foreign exchange (gains) losses		(7.1)	11.5
Share of profit of associate	16	(7.7)	(0.9)
Net other investment (income) losses	3	(0.7)	0.5
Net realised (gains) losses and impairments	3	(11.8)	(8.6)
Net unrealised losses on interest rate swaps		1.9	5.4
Loss on disposal of intangible asset		2.9	–
Changes in operational assets and liabilities			
– Insurance and reinsurance contracts		(17.7)	38.2
– Other assets and liabilities		8.1	22.9
Net cash flows from operating activities		**193.3**	**257.7**
Cash flows used in investing activities			
Interest and dividends received		49.1	59.6
Net purchase of property, plant and equipment		(0.2)	(0.6)
Purchase and development of intangible asset		(1.7)	(1.2)
Investment in associate	16	(23.6)	(50.0)
Purchase of fixed income securities		(1,681.8)	(1,944.5)
Purchase of equity securities		–	(87.4)
Proceeds on maturity and disposal of fixed income securities		1,541.4	1,939.0
Proceeds on disposal of equity securities		–	80.2
Net settlement of other investments		(3.2)	1.1
Net cash flows used in investing activities		**(120.0)**	**(3.8)**
Cash flows used in financing activities			
Interest paid		(5.5)	(5.6)
Issuance of long-term debt		130.0	–
Dividends paid	21	(201.4)	(444.4)
Distributions by trust		(8.7)	(4.5)
Net cash flows used in financing activities		**(85.6)**	**(454.5)**
Net decrease in cash and cash equivalents		**(12.3)**	**(200.6)**
Cash and cash equivalents at beginning of year		311.8	512.5
Effect of exchange rate fluctuations on cash and cash equivalents		(3.7)	(0.1)
Cash and cash equivalents at end of year	9	**295.8**	**311.8**

Summary of significant accounting policies
The basis of preparation, consolidation principles and significant accounting policies adopted in the preparation of LHL and the Group's consolidated financial statements are set out below.

Basis of preparation
The Group's consolidated financial statements are prepared in accordance with accounting principles generally accepted under IFRS as adopted by the European Union.

Where IFRS is silent, as it is in respect of the measurement of insurance products, the IFRS framework allows reference to another comprehensive body of accounting principles. In such instances, the Group determines appropriate measurement bases, to provide the most useful information to users of the consolidated financial statements, using their judgement and considering U.S. GAAP.

All amounts, excluding share data or where otherwise stated, are in millions of U.S. dollars.

While a number of new or amended IFRS and IFRIC standards have been issued there are no standards that have had a material impact on the Group.

IFRS 4, Insurance Contracts, issued in March 2004, specifies the financial reporting for insurance contracts by an insurer. The current standard is Phase I in the IASB's insurance contract project and, as noted above, does not specify the recognition or measurement of insurance contracts. This will be addressed in Phase II of the IASB's project and is expected to include a number of significant changes regarding the measurement and disclosure of insurance contracts. The Group will continue to monitor the progress of the project in order to assess the potential impacts the new standard will have on its results and the presentation and disclosure thereof.

IFRS 9, Financial Instruments: Classification and Measurement, has been issued but is not yet effective, and therefore has not yet been adopted by the Group. The Group continues to apply IAS 39, Financial Instruments: Recognition and Measurement and classifies its fixed income and equity securities as available for sale. The new standard, the effective date of which has been deferred until 1 January 2015, is not expected to have a material impact on the results and disclosures reported in the consolidated financial statements. It will, however, result in a reclassification of fixed income securities from available for sale to estimated fair value through profit or loss and a reclassification of the net change in unrealised gains and losses on investments from accumulated other comprehensive income to profit or loss.

IFRS 10, Consolidated Financial Statements, issued in May 2011, redefines the principle of control and establishes control as the basis for determining which entities are consolidated in an entity's financial statements. IFRS 12, Disclosure of Involvement with Other Entities, was issued concurrently and sets out the disclosure requirements for consolidated financial statements. Both standards will be effective from 1 January 2014 and are not expected to have a material impact on the Group's results, although additional disclosures may be required.

The consolidated balance sheet of the Group is presented in order of decreasing liquidity.

Use of estimates
The preparation of financial statements in conformity with IFRS requires the Group to make estimates and assumptions that affect the reported and disclosed amounts at the balance sheet date and the reported and disclosed amounts of revenues and expenses during the reporting period. Actual results may differ materially from the estimates made.

The most significant estimate made by management is in relation to losses and loss adjustment expenses. This is discussed on page 77 and also in the risk disclosures section from page 86. Estimates in relation to losses and loss adjustment expenses recoverable are discussed on page 76.

Estimates may also be made in determining the estimated fair value of certain financial instruments and equity compensation plans. The estimation of the fair value of financial instruments is discussed on pages 77 and 78 and in note 10. Management judgement is applied in determining impairment charges. The estimation of the fair value of equity based compensation awards granted is discussed in Note 6.

Basis of consolidation
The Group's consolidated financial statements include the assets, liabilities, shareholders' equity, revenues, expenses and cash flows of LHL and its subsidiaries. A subsidiary is an entity in which the Group owns, directly or indirectly, more than 50% of the voting power of the entity or otherwise has the power to govern its operating and financial policies. Intercompany balances, profits and transactions are eliminated.

Subsidiaries' accounting policies are consistent with the Group's accounting policies.

Associates

Investments, in which the Group has significant influence over the operational and financial policies of the investee, are recognised at cost and thereafter accounted for using the equity method. Under this method, the Group records its proportionate share of income and loss from such investments in its statement of comprehensive income for the period. Adjustments are made to associates' accounting policies, where necessary, in order to be consistent with the Group's accounting policies.

Foreign currency translation

The functional currency, which is the currency of the primary economic environment in which operations are conducted, for all Group entities is U.S. dollars. Items included in the financial statements of each of the Group's entities are measured using the functional currency. The consolidated financial statements are also presented in U.S. dollars.

Foreign currency transactions are recorded in the functional currency for each entity using the exchange rates prevailing at the dates of the transactions, or at the average rate for the period when this is a reasonable approximation. Monetary assets and liabilities denominated in foreign currencies are translated at period end exchange rates. The resulting exchange differences on translation are recorded in the consolidated statement of comprehensive income. Non-monetary assets and liabilities carried at historical cost denominated in a foreign currency are translated at historic rates. Non-monetary assets and liabilities carried at estimated fair value denominated in a foreign currency are translated at the exchange rate at the date the estimated fair value was determined, with resulting exchange differences recorded in accumulated other comprehensive income in shareholders' equity.

Insurance contracts

Classification

Insurance contracts are those contracts that transfer significant insurance risk at the inception of the contract. Contracts that do not transfer significant insurance risk are accounted for as investment contracts. Insurance risk is transferred when an insurer agrees to compensate a policyholder if a specified uncertain future event adversely affects the policyholder.

Premiums and acquisition costs

Premiums are first recognised as written at the date that the contract is bound. The Group writes both excess of loss and pro-rata (proportional) contracts. For the majority of excess of loss contracts, written premium is recorded based on the minimum and deposit or flat premium, as defined in the contract. Subsequent adjustments to the minimum and deposit premium are recognised in the period in which they are determined. For pro-rata contracts and excess of loss contracts where no deposit is specified in the contract, written premium is recognised based on estimates of ultimate premiums provided by the insureds or ceding companies. Initial estimates of written premium are recognised in the period in which the contract is bound. Subsequent adjustments, based on reports of actual premium by the insureds or ceding companies, or revisions in estimates, are recorded in the period in which they are determined.

Premiums are earned rateably over the term of the underlying risk period of the insurance contract, except where the period of risk differs significantly from the contract period. In these circumstances, premiums are recognised over the period of risk in proportion to the amount of insurance protection provided. The portion of the premium related to the unexpired portion of the risk period is reflected in unearned premiums.

Where contract terms require the reinstatement of coverage after an insured's or ceding company's loss, the estimated mandatory reinstatement premiums are recorded as written premiums when a specific loss event occurs. Reinstatement premiums are not recorded for losses included within the provision for IBNR which do not relate to a specific loss event.

Inwards premiums receivable from insureds and cedants are recorded net of commissions, brokerage, premium taxes and other levies on premiums, unless the contract specifies otherwise. These balances are reviewed for impairment, with any impairment loss recognised as an expense in the period in which it is determined.

Acquisition costs represent commissions, brokerage, profit commissions and other variable costs that relate directly to the securing of new contracts and the renewing of existing contracts. They are generally deferred over the period in which the related premiums are earned to the extent they are recoverable out of expected future revenue margins. All other acquisition costs are recognised as an expense when incurred.

Outwards reinsurance

Outwards reinsurance premiums comprise the cost of reinsurance contracts entered into. Outwards reinsurance premiums are accounted for in the period in which the contract is bound. The provision for reinsurers' share of unearned premiums represents that part of reinsurance premiums ceded which are estimated to be earned in future financial periods. Unearned reinsurance commissions are recognised as a liability using the same principles. Contingent profit commissions on reinsurance contracts entered into with ARL are accrued when it is virtually certain that the income will be realised.

Any amounts recoverable from reinsurers are estimated using the same methodology as the underlying losses. The Group monitors the creditworthiness of its reinsurers on an ongoing basis and assesses any reinsurance assets for impairment, with any impairment loss recognised as an expense in the period in which it is determined.

Losses

Losses comprise losses and loss adjustment expenses paid in the period and changes in the provision for outstanding losses, including the provision for IBNR and related expenses. Losses and loss adjustment expenses are charged to income as they are incurred.

A significant portion of the Group's business is in classes with high attachment points of coverage, including property catastrophe. Reserving for losses in such programmes is inherently complicated in that losses in excess of the attachment level of the Group's policies are characterised by high severity and low frequency and other factors which could vary significantly as losses are settled. This limits the volume of industry loss experience available from which to reliably predict ultimate losses following a loss event. In addition, the Group has limited past loss experience, which increases the inherent uncertainty in estimating ultimate loss levels.

Losses and loss adjustment expenses represent the estimated ultimate cost of settling all losses and loss adjustment expenses arising from events which have occurred up to the balance sheet date, including a provision for IBNR. The Group does not discount its liabilities for unpaid losses. Outstanding losses are initially set on the basis of reports of losses received from third parties. ACRs are determined where the Group's best estimate of the reported loss is greater than that reported. Estimated IBNR reserves may also consist of a provision for additional development in excess of losses reported by insureds or ceding companies, as well as a provision for losses which have occurred but which have not yet been reported by insureds or ceding companies. IBNR reserves are set on a best estimate basis and are estimated by management using various actuarial methods as well as a combination of own loss experience, historical insurance industry loss experience, underwriters' experience, estimates of pricing adequacy trends and management's professional judgement.

The estimation of the ultimate liability arising is a complex process which incorporates a significant amount of judgement. It is reasonably possible that uncertainties inherent in the reserving process, delays in insureds or ceding companies reporting losses to the Group, together with the potential for unforeseen adverse developments, could lead to a material change in losses and loss adjustment expenses.

Liability adequacy tests

At each balance sheet date, the Group performs a liability adequacy test using current best estimates of future cash outflows generated by its insurance contracts, plus any investment income thereon. If, as a result of these tests, the carrying amount of the Group's insurance liabilities is found to be inadequate, the deficiency is charged to income for the period, initially by writing off deferred acquisition costs and subsequently by establishing a provision.

Financial instruments

Cash and cash equivalents

Cash and cash equivalents are carried in the consolidated balance sheet at amortised cost and include cash in hand, deposits held on call with banks and other short-term highly liquid investments with a maturity of three months or less at the date of purchase. Carrying amounts approximate fair value due to the short-term nature and high liquidity of the instruments.

Interest income earned on cash and cash equivalents is recognised on the effective interest rate method. The carrying value of accrued interest income approximates estimated fair value due to its short-term nature and high liquidity.

Investments

The Group's fixed income securities are quoted investments that are classified as available for sale and are carried at estimated fair value. The classification is determined at the time of initial purchase and depends on the category of investment. Investments with an embedded conversion option are designated as at estimated fair value through profit and loss. Movements in estimated fair value relate primarily to the option component.

Regular way purchases and sales of investments are recognised at estimated fair value including transaction costs on the trade date and are subsequently carried at estimated fair value. The estimated fair values of quoted investments are determined based on bid prices from recognised exchanges, broker-dealers, recognised indices or pricing vendors. Investments are derecognised when the Group has transferred substantially all of the risks and rewards of ownership. Realised gains and losses are included in income in the period in which they arise. Unrealised gains and losses from changes in estimated fair value of available for sale investments are included in accumulated other comprehensive income in shareholders' equity.

On derecognition of an investment, previously recorded unrealised gains and losses are removed from accumulated other comprehensive income in shareholders' equity and included in current period income.

Amortisation and accretion of premiums and discounts on available for sale fixed income securities are calculated using the effective interest rate method and are recognised in current period net investment income. Interest income is recognised on the effective interest rate method. The carrying value of accrued interest income approximates estimated fair value due to its short-term nature and high liquidity.

The Group reviews the carrying value of its available for sale investments for evidence of impairment. An investment is impaired if its carrying value exceeds the estimated fair value and there is objective evidence of impairment to the asset. Such evidence would include a prolonged decline in estimated fair value below cost or amortised cost, where other factors, such as expected cash flows, do not support a recovery in value. If an impairment is deemed appropriate, the difference between cost or amortised cost and estimated fair value is removed from accumulated other comprehensive income in shareholders' equity and charged to current period income. Impairment losses on fixed income securities may be subsequently reversed through income.

Derivative financial instruments
Derivatives are recognised at estimated fair value on the date a contract is entered into, the trade date, and are subsequently carried at estimated fair value. Derivative instruments with a positive estimated fair value are recorded as derivative financial assets and those with a negative estimated fair value are recorded as derivative financial liabilities.

Derivative financial instruments include exchange-traded future and option contracts, forward foreign currency contracts, interest rate swaps, credit default swaps and interest rate swaptions. They derive their value from the underlying instrument and are subject to the same risks as that underlying instrument, including liquidity, credit and market risk. Estimated fair values are based on exchange or broker-dealer quotations, where available, or discounted cash flow models, which incorporate the pricing of the underlying instrument, yield curves and other factors. Changes in the estimated fair value of instruments that do not qualify for hedge accounting are recognised in current period income. The Group does not hold any derivatives classified as hedging instruments. For discounted cash flow techniques, estimated future cash flows are based on management's best estimates and the discount rate used is an appropriate market rate.

Derivative financial assets and liabilities are offset and the net amount is reported in the consolidated balance sheet only to the extent there is a legally enforceable right of offset and there is an intention to settle on a net basis, or to realise the assets and liabilities simultaneously. Derivative financial assets and liabilities are derecognised when the Group has transferred substantially all of the risks and rewards of ownership or the liability is discharged, cancelled or expired.

Long-term debt
Long-term debt is recognised initially at fair value, net of transaction costs incurred. Thereafter it is held at amortised cost, with the amortisation calculated using the effective interest rate method. Derecognition occurs when the obligation has been extinguished.

Property, plant and equipment
Property, plant and equipment is carried at historical cost, less accumulated depreciation and any impairment in value. Depreciation is calculated to write-off the cost over the estimated useful economic life on a straight-line basis as follows:

IT equipment	33% per annum
Office furniture and equipment	33% per annum
Leasehold improvements	20% per annum

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date.

An item of property, plant or equipment is derecognised on disposal or when no future economic benefits are expected to arise from the continued use of the asset.

Gains and losses on the disposal of property, plant and equipment are determined by comparing proceeds with the carrying amount of the asset, and are included in the consolidated statement of comprehensive income. Costs for repairs and maintenance are charged to income as incurred.

Leases

Rentals payable under operating leases are charged to income on a straight-line basis over the lease term.

Employee benefits

Equity compensation plans

The Group currently operates an RSS under which nil-cost options have been granted. The Group has also operated a management warrant plan and an LTIP option plan in the past. The fair value of the equity instruments granted is estimated on the date of grant. The estimated fair value is recognised as an expense pro-rata over the vesting period of the instrument, adjusted for the impact of any non-market vesting conditions. No adjustment to vesting assumptions is made in respect of market vesting conditions.

At each balance sheet date, the Group revises its estimate of the number of RSS nil-cost options, LTIP options and warrants that are expected to become exercisable. It recognises the impact of the revision of original estimates, if any, in the consolidated statement of comprehensive income, and a corresponding adjustment is made to other reserves in shareholders' equity over the remaining vesting period.

On exercise, the differences between the expense charged to the consolidated statement of comprehensive income and the actual cost to the Group, if any, is transferred to contributed surplus. Where new shares are issued, the proceeds received are credited to share capital and share premium.

Pensions

The Group operates a defined contribution plan. On payment of contributions to the plan there is no further obligation to the Group. Contributions are recognised as employee benefits in the consolidated statement of comprehensive income in the period to which they relate.

Tax

Income tax represents the sum of the tax currently payable and any deferred tax. The tax payable is calculated based on taxable profit for the period. Taxable profit for the period can differ from that reported in the consolidated statement of comprehensive income due to certain items which are not tax deductible or which are deferred to subsequent periods.

Deferred tax is recognised on temporary differences between the assets and liabilities in the consolidated balance sheet and their tax base. Deferred tax assets or liabilities are accounted for using the balance sheet liability method. Deferred tax assets are recognised to the extent that realising the related tax benefit through future taxable profits is likely.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority.

Where the current estimated fair value of equity based compensation awards exceeds the estimated fair value at the time of grant, adjusted where applicable for dividends, the related corporation tax and deferred tax charge or credit is recognised directly in other reserves.

Own shares

Own shares include shares repurchased under share repurchase authorisations and held in treasury plus shares repurchased and held in trust for the purposes of employee equity based compensation schemes. Own shares are deducted from shareholders' equity. No gain or loss is recognised on the purchase, sale, cancellation or issue of own shares and any consideration paid or received is recognised directly in equity.

Risk disclosures: introduction

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 Group is insurance risk.

The primary objective of the Group's ERM is to ensure that the amount of capital held is consistent with the risk profile of the Group and therefore that the balance between risk and reward is considered as part of all key business decisions. The Group has formulated, and keeps under review, a risk appetite which is set by the Board of Directors. The Group's appetite to risk will vary marginally from time to time to reflect the potential risks and rewards that present themselves. However, protecting the Group's capital and providing investors with a superior risk-adjusted return over the long term are constants. The risk appetite of the Group is central to how the business is run and permeates into the risk appetites that the individual operating entity Boards of Directors have adopted. These risk appetites are expressed through detailed risk tolerances at both a Group and an operating entity level. Risk tolerances represent the maximum amount of capital that the Group and its entities are prepared to expose to certain risks.

The Group's Board of Directors is responsible for setting and monitoring the Group's risk appetite and tolerances whereas the individual entities Boards of Directors are responsible for setting and monitoring entity level risk tolerances. All risk tolerances are subject to at least an annual review and consideration by the respective Boards of Directors. The Group and individual entity Boards of Directors review actual risk levels versus tolerances, emerging risks and any risk learning events at least quarterly. In addition, usually on a fortnightly basis, management reviews the output from BLAST in order to assess modeled potential losses against risk tolerances and ensure that risk levels are managed in accordance with them.

Risk and Return Committee

The RRC seeks to optimise risk-adjusted return and facilitate the appropriate use of the internal model, including considering its effectiveness. It ensures that all key areas of risk are discussed according to a schedule that covers fortnightly, monthly, quarterly, semi-annual and annual reviews. The committee meets fortnightly and is responsible for coordinating and overseeing ERM activities within the risk profile, appetites and tolerances set by the Group and individual entity Boards of Directors. The RRC includes members from the finance, actuarial, underwriting and operations functions. The CRO attends the meetings and reports on the RRC's activities to the Group and individual entity Boards of Directors.

Chief Risk Officer

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

- drive ERM culture, ownership and execution on three levels; Board, executive management, and operationally within the business;
- facilitate the identification, assessment and evaluation of existing and emerging risks by management and the Board;
- ensure that these risks are given due consideration and embedded within management's and the Board's oversight and decision making process;
- be consulted, and opine on, policy in areas such as, but not limited to, underwriting, claims, investments, operations and capital management; and
- 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 owners 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 Group and individual entity risk registers, which are a direct input to BLAST. 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 Boards of Directors of the Group and the individual operating entities in this regard.

Internal audit

Internal audit plays a key role in the Group's ERM by providing an independent opinion regarding the accuracy and completeness of risks, in addition to verification of the effectiveness of controls. Internal audit's roles and responsibilities are clearly defined through the Internal Audit Charter. The Head of Internal Audit reports directly to the Group Audit Committee. The CRO receives a copy of each internal audit report and considers the findings and agreed actions in the context of the risk appetites and tolerances, plus the risk policies and risk management strategy of each area. The integration of internal audit and ERM into the business helps facilitate the Group's protection of its assets and reputation.

Economic capital model

The foundation of the Group's risk based capital approach to decision making is its economic capital model, BLAST, which is based on the widely accepted economic capital modeling tool, ReMetrica. Management uses BLAST primarily for monitoring its insurance risks. However, BLAST is also used to monitor other risks including market, credit and operational risks.

BLAST produces data in the form of a stochastic distribution for all classes, including non-elemental classes. The distribution includes the mean outcome and the result at various return periods, including very remote events. BLAST includes the calculation of present and projected financial outcomes for each insurance class, and also recognises diversification credit. This arises as individual risks are generally not strongly correlated and are unlikely to all produce profits or losses at the same time. BLAST also measures the Group's aggregate insurance exposures. It therefore helps senior management and the Board of Directors determine the level of capital required to meet the combined risk from a wide range of categories. Assisted by BLAST, the Group seeks to achieve an improved risk-adjusted return over time.

BLAST is used in strategic underwriting decisions, as part of the Group's annual business planning process and to assist in portfolio optimisation, taking account of inwards business and all major reinsurance purchases. Management also utilises BLAST in assessing the impact of strategic decisions on individual classes of business that the Group writes, or is considering writing, as well as the overall resulting financial impact to the Group. BLAST output, covering all of the risk groups the Group is exposed to, is reviewed, including the anticipated loss curves, combined ratios and risk-adjusted profitability, to determine profitability and risk tolerance headroom by class.

The six primary risk categories, insurance risk, market risk, liquidity risk, credit risk, operational risk and strategic risk, are discussed in detail below.

A. Insurance risk

The Group underwrites worldwide, predominantly short-tail, insurance and reinsurance contracts that transfer insurance risk, including risks exposed to both natural and man-made catastrophes. The Group'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. Insurance and reinsurance markets are cyclical and premium rates and terms and conditions vary by line of business depending on market conditions and the stage of the cycle. Market conditions are impacted by capacity and recent loss events, and broader economic cycle impacts amongst other factors. The Group's underwriters assess likely losses using their experience and knowledge of past loss experience, industry trends and current circumstances. This allows them to estimate the premiums sufficient to meet likely losses and expenses and desired levels of profitability consistent with the Group's risk-adjusted RoE targets.

The Group considers insurance risk at an individual contract level, at a sector level, a geographic level and at an aggregate portfolio level. This ensures careful risk selection, limits on concentration and appropriate portfolio diversification are accomplished. The Group's four principal classes, or lines, are Property, Energy, Marine and Aviation. These classes are deemed to be the Group's operating segments. The level of insurance risk tolerance per peril is set by the Board of Directors.

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;
- 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 and reviewed on an ongoing basis;
- BLAST is used to measure occurrence risks, aggregate risks and correlations between classes and other non-insurance risks;
- each authorised class has a predetermined normal maximum line structure;
- each underwriter has a clearly defined limit of underwriting authority;

- the Group and individual operating entities have predetermined tolerances on probabilistic and deterministic losses of capital for certain single events and aggregate losses over a period of time;
- risk levels versus tolerances are monitored on a regular basis;
- a daily underwriting call is held 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 modeling tools are deployed to model catastrophes and resultant losses to the portfolio and the Group; 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 modeled in BLAST.

Some of the Group's business provides coverage for natural catastrophes (e.g. hurricanes, earthquakes and floods) and is subject to potential seasonal variation. A proportion of the Group'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 Group's loss experience. The North American and Japanese wind seasons are typically June to November and the European wind season November to March. The Group 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. ARL bears exposure to catastrophe losses and any significant loss event could potentially result in impairment in the value of the Group's investment in AHL.

The Group's exposures to certain peak zone elemental losses, as a percentage of capital, including long-term debt, are shown below. Net loss estimates are before income tax and net of reinstatement premiums and outwards reinsurance. The exposure to catastrophe losses that would result in an impairment in the investment in AHL is included in the figures below.

		100 year return period estimated net loss		250 year return period estimated net loss	
As at 31 December 2012		$m	% of capital	$m	% of capital
Zones	Perils				
Gulf of Mexico(1)	Hurricane	324.4	19.7	462.5	28.1
Japan	Typhoon	164.2	10.0	369.9	22.5
Japan	Earthquake	158.4	9.6	288.2	17.5
California	Earthquake	106.7	6.5	263.9	16.0
Pan-European	Windstorm	191.9	11.7	257.8	15.7
Pacific North West	Earthquake	34.9	2.1	191.1	11.6

(1) Landing hurricane from Florida to Texas.

		100 year return period estimated net loss		250 year return period estimated net loss	
As at 31 December 2011		$m	% of capital	$m	% of capital
Zones	Perils				
Gulf of Mexico(1)	Hurricane	249.1	17.1	368.0	25.3
Japan	Typhoon	108.5	7.5	235.0	16.2
Japan	Earthquake	165.4	11.4	260.0	17.9
California	Earthquake	97.3	6.7	195.7	13.5
Pan-European	Windstorm	126.5	8.7	188.3	12.9
Pacific North West	Earthquake	43.7	3.0	124.9	8.6

(1) Landing hurricane from Florida to Texas.

There can be no guarantee that the modeled assumptions and techniques deployed in calculating these figures are accurate. There could also be an unmodeled loss which exceeds these figures. In addition, any modeled loss scenario could cause a larger loss to capital than the modeled expectation.

Details of annual gross premiums written by geographic area of risks insured are provided below:

	2012 $m	2012 %	2011 $m	2011 %
Worldwide offshore	309.1	42.7	284.3	45.0
Worldwide, including the U.S. and Canada(1)	176.8	24.5	119.4	18.9
U.S. and Canada	87.0	12.0	84.2	13.3
Far East	41.4	5.7	26.2	4.1
Europe	39.3	5.4	31.5	5.0
Worldwide, excluding the U.S. and Canada(2)	25.5	3.5	26.3	4.2
Middle East	8.1	1.1	8.5	1.3
Rest of world	37.1	5.1	51.9	8.2
Total	**724.3**	**100.0**	**632.3**	**100.0**

(1) Worldwide, including the U.S. and Canada, comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area.

(2) Worldwide, excluding the U.S. and Canada, comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area, but that specifically exclude the U.S. and Canada.

Details of annual gross premiums written by line of business are provided below:

	2012 $m	2012 %	2011 $m	2011 %
Property	356.5	49.2	279.8	44.2
Energy	240.9	33.3	229.0	36.2
Marine	81.0	11.2	76.4	12.1
Aviation	45.9	6.3	47.1	7.5
Total	**724.3**	**100.0**	**632.3**	**100.0**

Further details of the gross premiums written and the risks associated with each of these four principal lines of business are described on the following pages.

i. Property

Gross premiums written, for the year:

	2012 $m	2011 $m
Property retrocession	124.4	46.8
Property catastrophe excess of loss	96.8	82.0
Terrorism	62.9	68.4
Property political risk	41.1	20.4
Property direct and facultative	25.6	57.5
Other property	5.7	4.7
Total	**356.5**	**279.8**

Property retrocession is written on an excess of loss basis through treaty arrangements and covers elemental risks. Cover may be on a worldwide or regional basis and may cover specific risks or all catastrophe perils. Coverage may be given on an UNL basis meaning that loss payments are linked directly to the ceding company's own loss, or on an ILW basis meaning that loss payments are linked to the overall insured loss as measured by independent third-party loss index providers.

Property catastrophe excess of loss covers elemental risks and is written on an excess of loss treaty basis. The property catastrophe excess of loss portfolio is written within the U.S. and also internationally. Cover is offered for specific perils and regions or countries.

Terrorism business can be written either ground up or for primary or excess layers, with cover provided for U.S. and worldwide property risks, but typically excluding nuclear, chemical and biological coverage in most territories. Cover is generally provided to medium to large commercial and industrial enterprises. Policies are typically written for scheduled locations and exposure is controlled by setting limits on aggregate exposure within a 'blast zone' radius. Some national pools are also written, which may include nuclear, chemical and biological coverage.

Property political risk cover is written either ground up or on an excess of loss basis. Coverage that the Group provides in the political risk book is split between confiscation perils coverage and sovereign/quasi-sovereign obligor coverage. Confiscation perils coverage protects against CEND (Confiscation, Expropriation, Nationalisation, Deprivation) and may be extended to include other perils. Sovereign/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 Group does not cover against private obligor credit risk.

During 2012 the decision was taken to exit the property direct and facultative market due to declining pricing and weak policy wording. A small number of risks will continue to be written with modest lines to support client relationships in other classes of business. Cover is generally provided to medium to large commercial and industrial enterprises with high value locations for non-elemental perils, including fire and explosion, and elemental (natural catastrophe) perils which can include flood, windstorm, earthquake, brush fire, tsunami and tornado.

The Group is exposed to large natural catastrophe losses, such as windstorm and earthquake loss, primarily from assuming property catastrophe excess of loss and property retrocession portfolio risks, but also from its remaining property direct and facultative portfolio. Exposure to such events is controlled and measured by setting limits on aggregate exposures in certain classes per geographic zone and through loss modeling. The accuracy of the latter exposure analysis is limited by the quality of data and the effectiveness of the modeling. It is possible that a catastrophic event significantly exceeds the expected modeled event loss. The Group's appetite and exposure guidelines to large losses are set out on pages 81 and 82.

Reinsurance may be purchased to mitigate exposures to large natural catastrophe losses in the U.S., Canada and worldwide with certain exclusions. Reinsurance may also be purchased to reduce the Group's worldwide exposure to large risk losses. Reinsurance is typically purchased on an excess of loss basis however ILWs or quota share arrangements, such as with ARL, may be entered into.

ii. Energy

Gross premiums written, for the year:

	2012 $m	2011 $m
Worldwide offshore energy	148.9	140.3
Gulf of Mexico offshore energy	65.5	60.7
Construction energy	17.9	10.5
Onshore energy	5.6	8.6
Energy excess of loss	0.8	5.2
Other energy	2.2	3.7
Total	**240.9**	**229.0**

Energy risks are written mostly on a direct basis and may be ground up or for primary or excess layers on either a first loss or full value basis. Worldwide offshore energy policies are typically package policies which may include physical damage, business interruption and third party liability sections. Coverage can include fire and explosion and elemental risks. Individual assets covered can be high value and are therefore mostly written on a subscription basis, meaning that coverage is placed with multiple underwriters.

Gulf of Mexico offshore energy programmes cover elemental and non-elemental risks. Most policies have sub-limits on coverage for elemental losses. These programmes are exposed to Gulf of Mexico windstorms. Exposure to such events is controlled and measured through loss modeling. The accuracy of this exposure analysis is limited by the quality of data and the effectiveness of the modeling. It is possible that a catastrophic event significantly exceeds the expected modeled event loss. The Group's appetite and exposure guidelines to large losses are set out on pages 81 and 82.

Construction energy contracts generally cover all risks of platform and drilling units under construction at yards and offshore, during towing and installation. Onshore construction contracts are generally not written.

Onshore energy risks can include onshore Gulf of Mexico and worldwide energy installations and are largely subject to the same loss events as described above. Coverage is given on the same basis as the property direct and facultative market and, as with that portfolio, is now largely in run-off.

Energy excess of loss currently consists of excess of loss and ILW covers protecting underlying energy reinsurance portfolios.

Reinsurance protection may be purchased to protect a portion of loss from elemental and non-elemental energy claims, and from the accumulation of smaller, attritional losses. Reinsurance is typically purchased on an excess of loss basis but, from time to time, quota share arrangements may be entered into. Reinsurance may be purchased on a facultative or treaty basis.

iii. Marine
Gross premiums written, for the year:

	2012 $m	2011 $m
Marine hull and total loss	28.9	23.8
Marine hull war	18.8	17.7
Marine builders risk	16.4	20.0
Marine P&I clubs	10.6	11.0
Other marine	6.3	3.9
Total	**81.0**	**76.4**

With the exception of the marine P&I clubs, where excess layers are written, most policies are written on a ground-up basis. Marine hull and total loss is generally written on a direct basis and covers marine risks on a worldwide basis, primarily for physical damage. Marine builders risk covers the building of ocean going vessels in specialised yards worldwide and their testing and commissioning. Marine hull war is direct insurance of loss of vessels from war, piracy or terrorist attack. Marine P&I clubs is mostly the reinsurance of the International Group of Protection and Indemnity Clubs and covers marine liabilities. Marine cargo programmes are not normally written.

The largest expected exposure in the marine class is from physical loss rather than from elemental loss events.

Reinsurance may be purchased to reduce the Group's exposure to both large risk losses and an accumulation of smaller, attritional losses. Reinsurance is typically purchased on an excess of loss basis.

iv. Aviation
Gross premiums written, for the year:

	2012 $m	2011 $m
AV52	36.8	39.6
Other aviation	9.1	7.5
Total	**45.9**	**47.1**

AV52 is written on a risk attaching excess of loss basis and provides coverage for third-party liability, excluding own passenger liability, resulting from acts of war or hijack of aircraft. Cover excludes U.S. commercial airlines and certain other countries whose governments provide a backstop coverage. Other aviation business includes aviation hull war risks and contingent hull, as well as the satellite launch and orbit market which the Group re-entered in the third quarter of 2012.

The Group does not presently write general aviation hull and liability business.

Reinsurance may be purchased to mitigate exposures to an AV52 event loss. Reinsurance is typically purchased on a treaty excess of loss basis.

Reinsurance

The Group, in the normal course of business and in accordance with its risk management practices, seeks to reduce certain types of loss that may arise from events that could cause unfavourable underwriting results, and to improve the modeled risk-adjusted RoE by entering into reinsurance arrangements. Reinsurance does not relieve the Group of its obligations to policyholders. Under the Group's reinsurance security policy, reinsurers are assessed and approved as appropriate security based on their financial strength ratings, amongst other factors. The RRC has defined limits by reinsurer by rating and with an aggregate exposure to a rating band. The RRC considers reinsurers that are not rated or do not fall within the predefined rating categories on a case-by-case basis, and would usually require collateral to be posted to support such obligations. There are specific guidelines for these collateralised contracts. The RRC monitors the creditworthiness of its reinsurers on an ongoing basis and formally reviews the Group's reinsurance arrangements at least quarterly.

Reinsurance protection is typically purchased on an excess of loss basis, however may also include ILW covers or quota share arrangements, such as with ARL. The mix of reinsurance cover is dependent on the specific loss mitigation requirements, market conditions and available capacity. Reinsurance may also be purchased to optimise the risk-adjusted return of the underwriting portfolio. The structure varies between types of peril and subclass. The Group regularly reviews its catastrophe exposures and may purchase reinsurance in order to reduce the Group's net exposure to a large natural catastrophe loss and/or to reduce net exposures to other large losses. The Group can purchase both facultative and treaty reinsurance. There is no guarantee that reinsurance coverage will be available to meet all potential loss circumstances, as it is possible that the cover purchased is not sufficient. Any loss amount which exceeds the programme would be retained by the Group. Some parts of the reinsurance programme have limited reinstatements therefore the number of claims which may be recovered from second or subsequent losses in those particular circumstances is limited.

Insurance liabilities

For most insurance and reinsurance companies, the most significant judgement made by management is the estimation of loss and loss adjustment expense reserves. The estimation of the ultimate liability arising from claims made under insurance and reinsurance contracts is a critical estimate for the Group particularly given the nature of the business written.

Under generally accepted accounting principles, loss reserves are not permitted until the occurrence of an event which may give rise to a claim. As a result, only loss reserves applicable to losses incurred up to the reporting date are established, with no allowance for the provision of a contingency reserve to account for expected future losses or for the emergence of new types of latent claims. Claims arising from future events can be expected to require the establishment of substantial reserves from time to time. All reserves are reported on an undiscounted basis.

Loss and loss adjustment expense reserves are maintained to cover the Group's estimated liability for both reported and unreported claims. Reserving methodologies that calculate a point estimate for the ultimate losses are utilised, and then a range is developed around these point estimates. The point estimate represents management's best estimate of ultimate loss and loss adjustment expenses. The Group's internal actuaries review the reserving assumptions and methodologies on a quarterly basis with loss estimates being subject to a quarterly corroborative review by independent actuaries, using U.S. generally accepted actuarial principles. This independent review is presented to the Group's Audit Committee. The Group has also established Reserve Committees at the operating entity level, which have responsibility for the review of large claims and IBNR levels, their development and any changes in reserving methodology and assumptions.

The extent of reliance on management's judgement in the reserving process differs as to whether the business is insurance or reinsurance, whether it is short-tail or long-tail and whether the business is written on an excess of loss or on a pro-rata basis. Over a typical annual period, the Group expects to write the large majority of programmes on a direct excess of loss basis. The Group does not currently write a significant amount of long-tail business.

Insurance versus reinsurance

Loss reserve calculations for direct insurance business are not precise in that they deal with the inherent uncertainty of future contingent events. Estimating loss reserves requires management to make assumptions regarding future reporting and development patterns, frequency and severity trends, claims settlement practices, potential changes in the legal environment and other factors, such as inflation. These estimates and judgements are based on numerous factors and may be revised as additional experience or other data becomes available or reviewed as new or improved methodologies are developed or as current laws or regulations change.

Furthermore, as a broker market reinsurer, management must rely on loss information reported to brokers by other insurers who must estimate their own losses at the policy level, often based on incomplete and changing information. The information management receives varies by cedant and may include paid losses, estimated case reserves and an estimated provision for IBNR reserves. Additionally, reserving practices and the quality of data reporting may vary among ceding companies which adds further uncertainty to the estimation of the ultimate losses.

Short-tail versus long-tail
In general, claims relating to short-tail risks, such as the majority of risks underwritten by the Group, are reported more promptly than those relating to long-tail risks, including the majority of casualty risks. However, the timeliness of reporting can be affected by such factors as the nature of the event causing the loss, the location of the loss, and whether the losses are from policies in force with insureds, primary insurers or with reinsurers.

Excess of loss versus proportional
For excess of loss contracts, which make up the majority of the Group's business, management are aided by the fact that each policy has a defined limit of liability arising from one event. Once that limit has been reached, there is no further exposure to additional losses from that policy for the same event. For proportional business, an initial estimated loss and loss expense ratio is generally used. This is based upon information provided by the insured or ceding company and/or their broker and management's historical experience of that treaty, if any, and the estimate is adjusted as actual experience becomes known.

Time lags
There is a time lag inherent in reporting from the original claimant to the primary insurer to the broker and then to the reinsurer. Also, the combination of low claims frequency and high severity makes the available data more volatile and less useful for predicting ultimate losses. 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.

Uncertainty
As a result of the time lag described above, an estimation must be made of IBNR reserves, which consist of a provision for additional development in excess of the case reserves reported by insureds or ceding companies, as well as a provision for claims which have occurred but which have not yet been reported by insureds or ceding companies. Due to 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 Group underwrites, 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 as well as regulatory directives, with a consequent impact on reserving. The claims count on the types of insurance and reinsurance that the Group 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 Group is notified of changes to loss estimates.

As at 31 December 2012 management's estimates for IBNR represented 28.1% of total net loss reserves (2011 – 33.5%). The majority of the 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 Group were not made aware of by the balance sheet date.

B. Market risk
The Group is at risk of loss due to movements in market factors. The main risks include:

i. Insurance risk;
ii. Investment risk;
iii. Debt risk; and
iv. Currency risk.

These risks, and the management thereof, are described below.

i. Insurance risk
The Group is exposed to insurance market risk from several sources, including the following:

- the advent or continuation of a soft market, which may result in a stabilisation or decline in premium rates and/or terms and conditions for certain lines, or across all lines;
- the actions and reactions of key competitors, which may directly result in volatility in premium volumes and rates, fee levels and other input costs;
- market events which may cause a limit in the availability of cover, including unusual inflation in rates, causing political intervention or national remedies;
- failure to maintain broker and client relationships, leading to a limited or substandard choice of risks inconsistent with the Group's risk appetite; and
- changes in regulation including capital, governance or licensing requirements.

The most important method to mitigate insurance market risk is to maintain strict underwriting standards. The Group manages insurance market risk in numerous ways, including the following:

- reviews and amends underwriting plans and outlook as necessary;
- reduces exposure to market sectors where conditions have reached unattractive levels;
- purchases appropriate, cost-effective reinsurance cover to mitigate exposure;
- closely monitors changes in rates and terms and conditions;
- holds a daily underwriting meeting to discuss, inter alia, market conditions and opportunities;
- regularly reviews output from BLAST to assess up-to-date profitability of classes and sectors;
- holds a quarterly Underwriting and Underwriting Risk Committee meeting to review underwriting strategy;
- holds a fortnightly RRC meeting to monitor estimated exposures to peak zone elemental losses and realistic disaster scenarios; and
- holds ongoing documented meetings with regulators.

Insurance contract liabilities are not directly sensitive to the level of market interest rates, as they are undiscounted and contractually non-interest bearing.

ii. Investment risk
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 Group'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 external investment managers must operate. Important parameters include guidelines on permissible assets, 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 Investment Risk and Return Committee and the Board of Directors.

The Group's fixed income portfolios are managed by four external investment managers. The Group held a small allocation of equities for a short period of time in 2011. The equity portfolio was liquidated to limit the Group's exposure to further anticipated volatility. The performance of the managers is monitored on an ongoing basis.

Within the Group guidelines is a subset of guidelines for the portion of funds required to meet near-term obligations and cash flow needs following an extreme event. The funds to cover this potential liability are designated as the 'core' portfolio and the portfolio duration is matched to the duration of the insurance liabilities, within an agreed range. The core portfolio is invested in fixed income securities and cash and cash equivalents. The core portfolio may, at times, contain assets significantly in excess of those required to meet insurance liabilities or other defined funding needs. The subset of guidelines adds a further degree of requirements, including fewer allowable asset classes, higher credit quality, shorter duration and higher liquidity. The primary objectives of this portion of assets are capital preservation and providing liquidity to meet insurance and other near-term obligations.

Assets in excess of those required to be held in the core portfolio, are typically held in the 'core plus' or 'surplus' portfolios. The core plus portfolio is invested in fixed income securities and cash and cash equivalents. The surplus portfolio is invested in fixed income securities, derivative instruments and cash and cash equivalents and can also be invested in equity securities. The assets in the core plus and surplus portfolios are not matched to specific insurance liabilities. In general, the duration of the surplus portfolio is slightly longer than the core or core plus portfolio, while maintaining a focus on high quality assets.

The Group reviews the composition, duration and asset allocation of its investment portfolio on a regular basis in order to respond to changes in interest rates and other market conditions. If certain asset classes are anticipated to produce a higher return within management's risk tolerance, an adjustment in asset allocation may be made. Conversely, if the risk profile is expected to move outside of tolerance levels, adjustments may be made to reduce the risks in the portfolio.

The Group endeavours to maintain a market neutral investment portfolio in order to minimise losses during periods of heightened volatility. These scenarios represent what could, and most likely will occur (albeit not in the exact form of our chosen scenario). The Group also monitors the portfolio impact of more severe disaster scenarios consisting of extreme shocks.

The Investment Risk and Return Committee meets at least quarterly to ensure that the Group's strategic and tactical investment actions are consistent with investment risk preferences, appetite and risk and return objectives. The Investment Risk and Return Committee also helps further develop the risk tolerances to be incorporated into the ERM framework.

The investment mix of the fixed income portfolios is as follows:

	Core		Core plus		Surplus		Total	
As at 31 December 2012	$m	%	$m	%	$m	%	$m	%
– Short-term investments	24.4	1.3	88.9	4.7	1.5	0.1	114.8	6.1
– U.S. treasuries	97.8	5.2	52.5	2.8	64.6	3.5	214.9	11.5
– Other government bonds	5.5	0.3	11.9	0.6	133.5	7.1	150.9	8.0
– U.S. municipal bonds	2.7	0.1	9.2	0.5	16.7	0.9	28.6	1.5
– U.S. government agency debt	8.1	0.4	16.8	0.9	106.7	5.7	131.6	7.0
– Asset backed securities	18.1	1.0	32.6	1.7	23.2	1.2	73.9	3.9
– U.S. government agency mortgage backed securities	48.0	2.6	127.3	6.8	227.8	12.1	403.1	21.5
– Non-agency mortgage backed securities	1.9	0.1	2.3	0.1	4.3	0.3	8.5	0.5
– Agency commercial mortgage backed securities	–	–	1.2	0.1	0.4	–	1.6	0.1
– Non-agency commercial mortgage backed securities	1.1	0.1	5.1	0.3	23.4	1.2	29.6	1.6
– Bank loans	–	–	–	–	37.4	2.0	37.4	2.0
– Corporate bonds	142.3	7.6	264.1	14.1	273.2	14.6	679.6	36.3
Total fixed income securities	**349.9**	**18.7**	**611.9**	**32.6**	**912.7**	**48.7**	**1,874.5**	**100.0**

As at 31 December 2011	Core $m	Core %	Core plus $m	Core plus %	Surplus $m	Surplus %	Total $m	Total %
– Short-term investments	32.6	1.9	32.6	1.9	13.7	0.8	78.9	4.6
– U.S. treasuries	101.1	5.9	85.0	5.0	165.0	9.6	351.1	20.5
– Other government bonds	5.0	0.3	21.5	1.3	132.6	7.7	159.1	9.3
– U.S. municipal bonds	3.2	0.2	10.0	0.6	14.5	0.9	27.7	1.7
– U.S. government agency debt	9.8	0.6	11.9	0.7	61.3	3.6	83.0	4.9
– Asset backed securities	14.5	0.8	36.7	2.1	18.4	1.1	69.6	4.0
– U.S. government agency mortgage backed securities	28.2	1.6	101.3	5.9	130.8	7.6	260.3	15.1
– Non-agency mortgage backed securities	2.4	0.2	4.2	0.2	6.5	0.4	13.1	0.8
– Non-agency commercial mortgage backed securities	1.7	0.1	8.5	0.5	21.3	1.2	31.5	1.8
– Corporate bonds	113.7	6.6	238.5	13.9	238.3	13.9	590.5	34.4
– Corporate bonds – FDIC guaranteed	23.1	1.4	14.2	0.8	11.9	0.7	49.2	2.9
Total fixed income securities	**335.3**	**19.6**	**564.4**	**32.9**	**814.3**	**47.5**	**1,714.0**	**100.0**

Non-FDIC guaranteed corporate bonds, bank loans and non-U.S. sovereign bonds by country are as follows:

As at 31 December 2012	Financials $m	Other industries $m	Total corporate bonds and bank loans $m	Other government bonds $m	Total corporate bonds, bank loans and other government bonds $m
United States	137.6	290.9	428.5	–	428.5
Canada	67.1	15.0	82.1	28.6	110.7
United Kingdom	9.6	32.0	41.6	8.3	49.9
Australia	9.8	12.2	22.0	16.0	38.0
Norway	30.8	–	30.8	2.1	32.9
France	1.5	21.8	23.3	1.8	25.1
Netherlands	7.5	5.5	13.0	2.8	15.8
Switzerland	8.0	6.9	14.9	–	14.9
Sweden	14.4	–	14.4	–	14.4
Belgium	–	9.7	9.7	–	9.7
Denmark	–	–	–	9.0	9.0
Germany	–	4.9	4.9	1.8	6.7
Spain	2.7	1.2	3.9	2.3	6.2
Supranationals	1.4	–	1.4	–	1.4
Emerging market corporates	6.4	9.6	16.0	–	16.0
Emerging market sovereign	–	–	–	30.4	30.4
Emerging market agency	–	–	–	47.8	47.8
Other	2.5	8.0	10.5	–	10.5
Total	**299.3**	**417.7**	**717.0**	**150.9**	**867.9**

As at 31 December 2011	Financials $m	Other industries $m	Total corporate bonds $m	Other government bonds $m	Total corporate and other government bonds $m
United States	127.0	216.9	343.9	–	343.9
Canada	40.5	11.5	52.0	23.8	75.8
United Kingdom	16.8	23.6	40.4	15.8	56.2
Australia	4.7	5.0	9.7	14.4	24.1
Norway	21.5	–	21.5	1.9	23.4
Netherlands	3.5	8.9	12.4	10.5	22.9
France	1.7	15.0	16.7	–	16.7
Sweden	13.3	–	13.3	–	13.3
Switzerland	4.3	7.0	11.3	–	11.3
Belgium	–	7.2	7.2	–	7.2
Germany	–	5.0	5.0	–	5.0
Supranationals	1.5	–	1.5	–	1.5
Emerging market corporates	3.0	38.6	41.6	–	41.6
Emerging market sovereign	–	–	–	71.8	71.8
Emerging market agency	–	–	–	11.9	11.9
Other	2.5	11.5	14.0	9.0	23.0
Total	**240.3**	**350.2**	**590.5**	**159.1**	**749.6**

The sector allocation of the corporate bonds and bank loans is as follows:

As at 31 December	2012 $m	2012 %	2011 $m	2011 %
Financial	297.9	41.5	238.8	37.3
Financial – FDIC guaranteed	–	–	49.2	7.7
Industrial	379.9	53.0	277.5	43.4
Utility	37.8	5.3	43.2	6.8
Foreign agencies	–	–	29.5	4.6
Supranationals	1.4	0.2	1.5	0.2
Total	**717.0**	**100.0**	**639.7**	**100.0**

The Group’s net asset value is directly impacted by movements in the value of investments held. Values can be impacted by movements in interest rates, credit ratings, exchange rates and economic environment and outlook.

The Group’s investment portfolio is mainly comprised of fixed income securities and cash and cash equivalents. The Group has no exposure to valuation risk from equity securities. The estimated fair value of the Group’s fixed income portfolio is generally inversely correlated to movements in market interest rates. If market interest rates fall, the fair value of the Group’s fixed income securities would tend to rise and vice versa.

The sensitivity of the price of fixed income securities, and certain derivatives, to movements in interest rates is indicated by their duration. The greater a security's duration, the greater its price volatility to movements in interest rates. The sensitivity of the Group's fixed income and derivative investment portfolio to interest rate movements is detailed below, assuming linear movements in interest rates:

As at 31 December	2012 $m	2012 %	2011 $m	2011 %
Immediate shift in yield (basis points)				
100	(40.9)	(2.2)	(36.2)	(2.1)
75	(30.6)	(1.6)	(27.1)	(1.6)
50	(20.4)	(1.1)	(18.1)	(1.1)
25	(10.2)	(0.5)	(9.0)	(0.5)
(25)	8.5	0.5	8.7	0.5
(50)	17.1	0.9	17.3	1.0
(75)	25.6	1.4	26.0	1.5
(100)	34.1	1.8	34.6	2.0

The Group mitigates interest rate risk on the investment portfolio by establishing and monitoring duration ranges in its investment guidelines. The Group may manage duration through the use of interest rate futures from time to time. The duration of the core portfolio is matched to the modeled duration of the insurance reserves, within a permitted range. The permitted duration range for the core plus portfolio is between zero and four years and the surplus portfolio is between one and five years.

The durations of the externally managed portfolios are as follows:

As at 31 December	2012 years	2011 years
Core portfolio	1.5	1.3
Core plus portfolio	1.5	1.2
Surplus portfolio	2.4	2.8
Overall portfolio	**1.9**	**2.0**

The overall duration for fixed income, managed cash and cash equivalents and certain derivatives is 1.8 years (2011 – 1.8 years).

In addition to duration management, the Group uses VaR on a monthly basis to measure potential losses in the estimated fair values of its cash and invested assets and to understand and monitor risk. The Group also models various periods of significant stress in order to better understand the investment portfolios' risks and exposures.

The VaR calculation is performed using variance/covariance risk modeling to capture the cash flows and embedded optionality of the portfolio. Securities are valued individually using market standard pricing models. These security valuations serve as the input to many risk analytics, including full valuation risk analyses, as well as parametric methods that rely on option adjusted risk sensitivities to approximate the risk and return profiles of the portfolio.

The principal VaR measure that is produced is a 90 day VaR at the 95th percentile confidence level. Management also monitors the 99th percentile confidence level. The 90 day VaR, at the 95th percentile confidence level, measures the minimum amount the assets should be expected to lose in a 90 day time horizon, under normal conditions, 5% of the time. The current VaR tolerance is 4.0% of shareholders' equity, using the 90 day VaR at the 95th percentile confidence level.

The Group's 90 day VaR calculations are as follows:

As at 31 December	2012 $m	2012 %	2011 $m	2011 %
95th percentile confidence level	13.4	1.0	18.5	1.4
99th percentile confidence level	19.0	1.4	26.1	2.0

Derivative financial instruments

The Group's investment guidelines permit the investment managers to utilise exchange-traded futures and options contracts, and OTC instruments including interest rate swaps, credit default swaps, interest rate swaptions and forward foreign currency contracts. Derivatives are used for yield enhancement, duration management, interest rate and foreign currency exposure management or to obtain an exposure to a particular financial market. These positions are monitored regularly. The Group may also use internally managed derivatives to mitigate interest rate risk and foreign currency exposures. The Group principally has exposure to derivatives related to the following types of risks: foreign currency risk, interest rate risk and credit risk.

The Group currently invests in the following derivative financial instruments:

a. TBAs;
b. Futures;
c. Options;
d. Forward foreign currency contracts;
e. Swaps; and
f. Swaptions.

The net gains or losses on the Group's derivative financial instruments recognised in the consolidated statement of comprehensive income are as follows:

As at 31 December 2012	Net other investment income $m	Net realised gains (losses) $m	Net foreign exchange gains (losses) $m	Financing costs $m
Eurodollar futures	–	0.2	–	–
Treasury futures	–	(1.7)	–	–
Forward foreign currency contracts	–	–	(2.8)	–
Interest rate swaps – investments	0.2	–	–	–
Interest rate swaps – debt	–	–	–	(4.1)
Credit default swaps	0.5	(0.1)	–	–
Total	**0.7**	**(1.6)**	**2.8**	**(4.1)**

As at 31 December 2011	Net other investment income $m	Net realised gains (losses) $m	Net foreign exchange gains (losses) $m	Financing costs $m
Eurodollar futures	–	1.6	–	–
Treasury futures	–	(1.6)	–	–
Forward foreign currency contracts	–	–	2.1	–
Interest rate swaps – investments	(0.1)	(0.2)	–	–
Interest rate swaps – debt	–	–	–	(7.4)
Credit default swaps	(0.4)	–	–	–
Total	**(0.5)**	**(0.2)**	**2.1**	**(7.4)**

The estimated fair values of the Group's derivative instruments are as follows:

	2012			2011		
As at 31 December	Other investments $m	Other assets $m	Interest rate swap $m	Other investments $m	Other assets $m	Interest rate swap $m
Forward foreign currency contracts	–	–	–	0.1	0.2	–
Interest rate swaps – investments	–	–	–	(0.2)	–	–
Interest rate swaps – debt	–	–	(8.0)	–	–	(6.1)
Credit default swaps	0.1	–	–	(0.5)	–	–
Total	**0.1**	**–**	**(8.0)**	**(0.6)**	**0.2**	**(6.1)**

a. TBAs
The TBA market is essentially a forward or delayed delivery market for mortgage backed securities issued by U.S. government agencies, where securities of a specific term and interest rate are bought or sold for future settlement on a 'to be announced' basis. TBAs are generally physically settled and classified as available for sale fixed income securities. Occasionally TBAs may be traded for net settlement. Such instruments are deemed to be derivative instruments. All TBAs classified as derivatives are held on a non-leveraged basis. The credit exposure is restricted to the differential between the settlement value of the forward purchase and the forward sale. The creditworthiness of the counterparty is monitored and collateral may be required on open positions.

The Group did not hold any TBA positions as at 31 December 2012 and 2011.

b. Futures
The Group's investment guidelines permit the use of futures which provide the Group with participation in market movements, determined by the underlying instrument on which the futures contract is based, without holding the instrument itself or the individual securities. This approach allows the Group more efficient and less costly access to the exposure than would be available by the exclusive use of individual fixed income and money market securities. Exchange-traded futures contracts may also be used as substitutes for ownership of the physical securities.

All futures contracts are held on a non-leveraged basis. An initial margin is provided, which is a deposit of cash and/or securities in an amount equal to a prescribed percentage of the contract value. The fair value of futures contracts is estimated daily and the margin is adjusted accordingly with unrealised gains and/or losses settled daily in cash and/or securities. A realised gain or loss is recognised when the contract is closed.

Futures contracts expose the Group to market risk to the extent that adverse changes occur in the estimated fair values of the underlying securities. Exchange-traded futures are, however, subject to a number of safeguards to ensure that obligations are met. These include the use of clearing houses (thus reducing counterparty credit risk), the posting of margins and the daily settlement of unrealised gains and losses. The amount of credit risk is therefore considered low. The investment guidelines restrict the maximum notional futures position as a percentage of the investment portfolio's estimated fair value.

As at 31 December 2012 the net notional short exposure to treasury futures is $56.2 million (2011 – $0.6 million)

A Eurodollar futures contract is an exposure to 3 month LIBOR, based on a commitment to a $1.0 million deposit. The estimated fair value is based on expectations of 3 month LIBOR, is determined using exchange-traded prices and was negligible as at 31 December 2012 and 2011. The contracts currently held by the Group will expire in 2014 and 2015.

The sensitivity of the Group's Eurodollar futures position to interest rate movements is not material at 31 December 2012 and 2011.

c. Options
The Group's investment guidelines permit the use of exchange-traded options on U.S. treasury futures and Eurodollar futures, which are used to manage exposure to interest rate risk and also to hedge duration. Exchange-traded options are held on a similar basis to futures and are subject to similar safeguards. Options are contractual arrangements that give the purchaser the right, but not the obligation, to either buy or sell an instrument at a specific set price at a predetermined future date. The Group may enter into option contracts that are secured by holdings in the underlying securities or by other means which permit immediate satisfaction of the Group's obligations. The notional amount of options is not material at 31 December 2012 and 2011.

The investment guidelines also restrict the maximum notional options exposure as a percentage of the investment portfolio's estimated fair value.

d. Forward foreign currency contracts

A forward foreign currency contract is a commitment to purchase or sell a foreign currency at a future date, at a defined rate. The Group may utilise forward foreign currency contracts to gain exposure to a certain currency or market rate or manage the impact of fluctuations in foreign currencies on the value of its foreign currency denominated investments and/or insurance related currency exposures.

Forward contracts expose the Group to credit, market and liquidity risks. Credit risk arises from the potential inability of counterparties to perform under the terms of the contract. The Group is exposed to market risk to the extent that adverse changes occur in the exchange rate of the underlying foreign currency. Liquidity risk represents the possibility that the Group may not be able to rapidly adjust the size of its forward positions at a reasonable price in times of high volatility and financial stress. These risks are mitigated by requiring a minimum counterparty credit quality, restricting the maximum notional exposure as a percentage of the investment portfolio's estimated fair value and restricting exposures to foreign currencies, individually and in aggregate, as a percentage of the investment portfolio's estimated fair value.

The notional amount of a derivative contract is the underlying quantity upon which payment obligations are calculated. A long position is equivalent to buying the underlying currency whereas a short position is equivalent to having sold the underlying currency.

The Group has the following open forward foreign currency contracts:

	2012			2011		
As at 31 December	Notional long $m	Notional short $m	Net notional long (short) $m	Notional long $m	Notional short $m	Net notional long (short) $m
Canadian Dollar	0.3	22.2	(21.9)	0.3	21.8	(21.5)
Euro	1.9	19.1	(17.2)	0.6	12.0	(11.4)
Australian Dollar	–	12.5	(12.5)	–	10.7	(10.7)
British Pound	0.1	3.9	(3.8)	–	1.3	(1.3)
Brazilian Real	–	3.3	(3.3)	5.3	9.2	(3.9)
Mexican Peso	–	0.2	(0.2)	3.5	3.6	(0.1)
South African Rand	–	0.1	(0.1)	4.8	4.9	(0.1)
Chinese Renminbi	3.4	3.4	–	5.6	5.6	–
Japanese Yen	–	–	–	24.3	0.3	24.0
Russian Ruble	–	–	–	4.5	4.5	–
Turkish Lira	–	–	–	3.5	3.5	–
Indonesian Rupiah	–	–	–	3.4	3.4	–
Malaysian Ringgit	–	–	–	2.4	2.4	–
Other[(1)]	–	–	–	8.7	8.7	–
Total	**5.7**	**64.7**	**(59.0)**	**66.9**	**91.9**	**(25.0)**

(1) Individual currencies included in 'other' have a notional payable and receivable of less than $2.0 million.

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e. Swaps

The Group's investment guidelines permit the use of interest rate swaps and credit default swaps which are primarily traded OTC. These are subject to credit risk on the counterparty's inability to perform. Swaps are recorded at estimated fair value at the end of each period with unrealised gains and losses recorded in the consolidated statement of comprehensive income.

Interest rate swaps are used to manage interest rate exposure, portfolio duration or capitalise on anticipated changes in interest rate volatility without investing directly in the underlying securities. Interest rate swap agreements entail the exchange of commitments to pay or receive interest, such as an exchange of floating rate payments for fixed rate payments, with respect to a notional amount of principal. These agreements involve elements of credit and market risk. Such risks include the possibility that there may not be a liquid market, that the counterparty may default on its obligation to perform or that there may be unfavourable movements in interest rates. These risks are mitigated through defining a minimum counterparty credit quality and a maximum notional exposure to interest rate swaps as a percentage of the investment portfolio's estimated fair value. The notional amount of interest rate swaps is not material at 31 December 2012 and 2011.

The Group uses credit default swaps as a way to add or reduce credit risk to an individual issuer, or a basket of issuers, without investing directly in their securities. As at 31 December 2012, the maximum amount of loss the Group could incur on its open credit default swaps was the notional value of $11.5 million (2011 – $20.8 million).

f. Swaptions

The Group uses swaptions, options on interest rate swaps, to manage interest rate risk exposure and portfolio and yield curve duration. The Group, as a purchaser of a swaption, is subject to the credit risk of the counterparty but is only subject to market risk to the extent of the premium paid. As a swaption writer, the Group is not subject to credit risk but is subject to market risk, due to its obligation to make payments under the terms of the contract. These risks are mitigated through maximum allowable notional exposures as a percentage of the investment portfolio's estimated fair value. The notional amount of swaptions is not material at 31 December 2012 and 2011.

iii. Debt risk

The Group has issued long-term debt as described in note 20. The subordinated loan notes due in 2035 bear interest at a floating rate that is reset on a quarterly basis, plus a fixed margin of 3.70%. The Group is subject to interest rate risk on the coupon payments of these subordinated loan notes. The Group has mitigated the interest rate risk by entering into interest rate swap contracts as follows:

	Maturity date	Interest hedged
Subordinated loan notes $97.0 million	15 December 2035	100%
Subordinated loan notes €24.0 million	15 June 2035	100%

Two-thirds of the U.S. dollar swaps expire on 15 March 2016 while the remaining balance expires on 3 August 2016. The Euro swaps expire on 4 August 2016. Therefore the Group currently has no interest rate risk on the subordinated loan notes due in 2035.

The senior unsecured notes maturing 1 October 2022 bear interest at a fixed rate of 5.70% and therefore the Group is not exposed to interest rate risk on this long-term debt.

iv. Currency risk

The Group underwrites from two locations, Bermuda and London, although risks are assumed on a worldwide basis. Risks assumed are predominantly denominated in U.S. dollars.

The Group is exposed to currency risk to the extent its assets are denominated in different currencies to its liabilities. The Group 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 income.

The Group hedges non-U.S. dollar liabilities primarily with non-U.S. dollar assets, but may also use derivatives to mitigate foreign currency exposures. The Group's main foreign currency exposure relates to its insurance obligations, cash holdings, premiums receivable, dividends payable and the €24.0 million subordinated loan notes long-term debt liability. The Group also has a small exposure to foreign currencies through its EMD investment portfolio. These positions may not be hedged depending on the currency outlook. See page 95 for a listing of the Group's open forward foreign currency contracts.

The Group's assets and liabilities, categorised by currency at their translated carrying amount were as follows:

Assets	U.S. $ $m	Sterling $m	Euro $m	Japanese Yen $m	Other $m	Total $m
Cash and cash equivalents	123.4	8.9	93.7	59.0	10.8	295.8
Accrued interest receivable	9.2	–	0.1	–	–	9.3
Fixed income securities	1,813.6	3.8	17.0	–	40.1	1,874.5
Other investments	0.1	–	–	–	–	0.1
Reinsurance assets	87.8	–	–	1.2	–	89.0
Deferred acquisition costs	53.2	1.2	6.7	1.3	5.6	68.0
Other receivables	2.5	0.6	–	–	–	3.1
Inwards premiums receivable from insureds and cedants	168.3	2.4	20.4	2.9	13.0	207.0
Deferred tax asset	–	7.3	–	–	–	7.3
Investment in associates	82.1	–	–	–	–	82.1
Property, plant and equipment	1.7	1.1	–	–	–	2.8
Total assets as at 31 December 2012	**2,341.9**	**25.3**	**137.9**	**64.4**	**69.5**	**2,639.0**

Liabilities	U.S. $ $m	Sterling $m	Euro $m	Japanese Yen $m	Other $m	Total $m
Losses and loss adjustment expenses	336.8	6.7	67.0	110.1	16.8	537.4
Unearned premiums	271.7	6.4	31.2	12.1	21.9	343.3
Insurance contracts – other payables	19.4	0.1	2.0	–	2.0	23.5
Amounts payable to reinsurers	30.6	–	–	–	–	30.6
Deferred acquisition costs ceded	0.6	–	–	0.2	–	0.8
Other payables	35.1	12.4	1.8	–	–	49.3
Interest rate swap	5.6	–	2.4	–	–	8.0
Long-term debt	227.0	–	31.7	–	–	258.7
Total liabilities as at 31 December 2012	**926.8**	**25.6**	**136.1**	**122.4**	**40.7**	**1,251.6**

Assets	U.S. $ $m	Sterling $m	Euro $m	Japanese Yen $m	Other $m	Total $m
Cash and cash equivalents	153.9	10.2	80.8	60.9	6.0	311.8
Accrued interest receivable	10.0	–	–	–	–	10.0
Fixed income securities	1,664.4	1.3	10.8	–	37.5	1,714.0
Other investments	(0.6)	–	–	–	–	(0.6)
Reinsurance assets	84.7	–	–	–	–	84.7
Deferred acquisition costs	46.9	1.0	7.0	0.9	5.6	61.4
Other receivables	47.9	0.7	–	–	–	48.6
Inwards premiums receivable from insureds and cedants	160.1	3.4	26.6	5.7	16.3	212.1
Deferred tax asset	–	8.2	–	–	–	8.2
Investment in associate	50.9	–	–	–	–	50.9
Property, plant and equipment	3.6	1.7	–	–	–	5.3
Intangible asset	–	1.2	–	–	–	1.2
Total assets as at 31 December 2011	**2,221.8**	**27.7**	**125.2**	**67.5**	**65.4**	**2,507.6**

Liabilities	U.S. $ $m	Sterling $m	Euro $m	Japanese Yen $m	Other $m	Total $m
Losses and loss adjustment expenses	319.2	6.9	67.4	161.5	16.2	571.2
Unearned premiums	279.0	7.4	29.0	8.3	23.4	347.1
Insurance contracts – other payables	16.2	0.1	5.6	–	1.6	23.5
Amounts payable to reinsurers	17.8	–	–	–	–	17.8
Deferred acquisition costs ceded	0.7	–	–	–	–	0.7
Other payables	75.6	10.3	0.4	–	0.1	86.4
Interest rate swap	4.8	–	1.3	–	–	6.1
Long-term debt	97.0	–	31.0	–	–	128.0
Total liabilities as at 31 December 2011	**810.3**	**24.7**	**134.7**	**169.8**	**41.3**	**1,180.8**

The impact on net income of a proportional foreign exchange movement of 10% up and 10% down against the U.S. dollar at the year end spot rates would be an increase or decrease of $2.0 million (2011 – $4.2 million).

The 31 December 2012 losses and loss adjustment expenses include the equivalent of $55.4 million (2011 – $57.1 million) of Japanese Yen denominated insurance liabilities that are contained within the Group's outwards reinsurance programme which limits the Group's net liability to $30.0 million. The Group has therefore not hedged the foreign currency exposure in relation to these losses.

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

The maturity dates of the Group's fixed income portfolio are as follows:

As at 31 December 2012	Core $m	Core plus $m	Surplus $m	Total $m
Less than one year	89.7	174.6	47.4	311.7
Between one and two years	98.5	127.9	80.1	306.5
Between two and three years	39.7	44.6	59.2	143.5
Between three and four years	10.0	24.1	66.5	100.6
Between four and five years	36.6	55.5	185.4	277.5
Over five years	6.3	16.7	195.0	218.0
Asset backed and mortgage backed securities	69.1	168.5	279.1	516.7
Total fixed income securities	**349.9**	**611.9**	**912.7**	**1,874.5**

As at 31 December 2011	Core $m	Core plus $m	Surplus $m	Total $m
Less than one year	118.5	117.5	47.5	283.5
Between one and two years	79.2	128.7	139.9	347.8
Between two and three years	60.0	114.2	136.8	311.0
Between three and four years	9.0	19.1	37.7	65.8
Between four and five years	16.4	28.0	60.4	104.8
Over five years	5.4	6.2	215.0	226.6
Asset backed and mortgage backed securities	46.8	150.7	177.0	374.5
Total fixed income securities	**335.3**	**564.4**	**814.3**	**1,714.0**

The maturity profile of the financial liabilities of the Group is as follows:

	Years until liability becomes due – undiscounted values					
As at 31 December 2012	Balance sheet $m	Less than one $m	One to three $m	Three to five $m	Over five $m	Total $m
Losses and loss adjustment expenses	537.4	243.0	193.1	59.7	41.6	537.4
Insurance contracts – other payables	23.5	18.2	4.8	0.5	–	23.5
Amounts payable to reinsurers	30.6	30.6	–	–	–	30.6
Other payables	49.3	49.3	–	–	–	49.3
Interest rate swap	8.0	2.6	4.6	0.8	–	8.0
Long-term debt	258.7	10.6	25.1	25.1	383.5	444.3
Total	**907.5**	**354.3**	**227.6**	**86.1**	**425.1**	**1,093.1**

	Years until liability becomes due – undiscounted values					
As at 31 December 2011	Balance sheet $m	Less than one $m	One to three $m	Three to five $m	Over five $m	Total $m
Losses and loss adjustment expenses	571.2	244.9	214.6	68.3	43.4	571.2
Insurance contracts – other payables	23.5	18.0	5.3	0.2	–	23.5
Amounts payable to reinsurers	17.8	17.8	–	–	–	17.8
Other payables	85.2	85.2	–	–	–	85.2
Corporation tax payable	1.2	1.2	–	–	–	1.2
Interest rate swap	6.1	1.8	2.7	1.6	–	6.1
Long-term debt	128.0	5.4	11.4	11.4	235.7	263.9
Total	**833.0**	**374.3**	**234.0**	**81.5**	**279.1**	**968.9**

Actual maturities of the above may differ from contractual maturities because certain borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties. The prepayment options for the Group's long-term debt are discussed in note 20. While the estimation of the ultimate liability for losses and loss adjustment expenses is complex and incorporates a significant amount of judgement, the timing of payment of losses and loss adjustment expenses is also uncertain and cannot be predicted as simply as for other financial liabilities. Actuarial and statistical techniques, past experience and management's judgement have been used to determine a likely settlement pattern.

The Group 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 Group 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 Group monitors market changes and outlooks and reallocates assets as deemed necessary.

D. Credit risk

Credit risk is the risk that a counterparty may fail to pay, or repay, a debt or obligation. The Group is exposed to credit risk on its fixed income investment portfolio and derivative instruments, its inwards premiums receivable from insureds and cedants, and on any amounts recoverable from reinsurers.

Credit risk on the fixed income portfolio is mitigated through the Group's policy to invest in instruments of high credit quality issuers and to limit the amounts 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% of shareholders' equity. In addition, no one issuer, with the exception of U.S. government and agency securities, other G10 government guaranteed securities (excluding Italy) and Australian sovereign debt, should exceed 5% of shareholders' equity. The Group is therefore not exposed to any significant credit concentration risk on its investment portfolio, except for fixed income securities issued by the U.S. government and government agencies.

Credit risk on exchange-traded derivative instruments is mitigated by the use of exchange-traded instruments which use clearing houses to reduce counterparty credit risk, require the posting of margins and settle unrealised gains and losses daily. Credit risk on OTC derivatives is mitigated by monitoring the creditworthiness of the counterparties and by requiring collateral to be posted for positions which are in the money by amounts exceeding predetermined thresholds.

Credit risk on inwards premiums receivable from insureds and cedants is managed by conducting business with reputable broking organisations, with whom the Group has established relationships, and by rigorous cash collection procedures. The Group also has a broker approval process in place. Credit risk from reinsurance recoverables is primarily managed by the review and approval of reinsurer security by the RRC as discussed on page 86. Reinsurance recoverables from ARL are fully collateralised by $238.4 million of funds held in a collateral account consisting of cash and cash equivalents and fixed income securities which are of high quality and short duration.

The table below presents an analysis of the Group'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 2012	Other investments $m	Cash and fixed income securities $m	Inwards premiums receivable and other receivables $m	Reinsurance recoveries $m
AAA	–	425.5	–	–
AA+, AA, AA-	–	901.7	–	–
A+, A, A-	–	579.2	4.5	55.3
BBB+, BBB, BBB-	0.1	189.0	–	–
Other(1)	–	74.9	209.7	17.7
Total	**0.1**	**2,170.3**	**214.2**	**73.0**

(1) Reinsurance recoveries classified as "other" relate to contracts with ARL and are fully collateralised.

As at 31 December 2011	Other investments $m	Cash and fixed income securities $m	Inwards premiums receivable and other receivables $m	Reinsurance recoveries $m
AAA	–	407.5	–	–
AA+, AA, AA-	–	883.9	–	–
A+, A, A-	(0.6)	519.5	6.2	69.7
BBB+, BBB, BBB-	–	165.9	–	–
Other	–	49.0	260.7	–
Total	**(0.6)**	**2,025.8**	**266.9**	**69.7**

The counterparty to the Group's long-term debt interest rate swap is currently rated A- by S&P.

The following table shows inwards premiums receivable that are past due but not impaired:

	2012 $m	2011 $m
Less than 90 days past due	5.2	10.5
Between 91 and 180 days past due	0.2	0.3
Over 180 days past due	–	0.1
Total	**5.4**	**10.9**

Provisions of $0.5 million (2011 – $0.8 million) have been made for impaired or irrecoverable balances and $0.8 million was released from (2011 – $0.3 million charged to) the consolidated statement of comprehensive income in respect of bad debts. No provisions have been made against balances recoverable from reinsurers.

E. Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes or systems. The Group and its subsidiaries have identified and evaluated their key operational risks and these are incorporated in the risk registers and modeled directly within BLAST. The Group has also established, and monitors compliance with, internal operational risk tolerances. The RRC reviews operational risk on a quarterly basis.

In order to manage operational risks, the Group 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.

F. Strategic risk

The Group 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 Group has also identified risks of the failure to maintain adequate capital, accessing capital at an inflated cost or the inability to access 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. Lastly, the Group has identified succession planning, staff retention and key man risks as strategic risks.

i. Business plan risks

The Group addresses the risks associated with the planning and execution of the business plan through a combination of the following:

- an iterative annual business planning process with cross departmental involvement;
- evaluation of and approval of the annual business plan by the 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 underwriting and marketing conference call.

ii. Capital management risk

The total capital of the Group is as follows:

As at 31 December	2012 $m	2011 $m
Shareholders' equity	1,387.4	1,326.8
Long-term debt	258.7	128.0
Total capital	**1,646.1**	**1,454.8**

Risks associated with the effectiveness of the Group's capital management are mitigated as follows:

- regular monitoring of current regulatory and rating agency capital requirements;
- oversight of capital requirements by the Board of Directors; and
- maintaining contact with vendors, regulators and rating agencies in order to stay abreast of upcoming developments.

The Group reviews the level and composition of capital on an ongoing basis with a view to:

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

Capital is increased or returned as appropriate. The retention of earnings generated leads to an increase in capital. Capital raising can include debt or equity and returns of capital may be made through dividends, share repurchases, a redemption of debt or any combination thereof. Other capital management tools and products available to the Group may also be utilised. All capital actions require approval by the Board of Directors.

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. Management increasingly use these approaches in decision making. The operating entities also conduct capital requirement assessments under internal measures and local regulatory requirements. Refer to note 27 for a discussion of the regulatory capital requirements of the Group's operating entities.

The Group's aim is to provide its shareholders with an RoE of 13% in excess of a risk-free rate over the insurance cycle. The return is generated within a broad framework of risk parameters. The return is measured by management in terms of the IRR of the increase in FCBVS in the period adjusted for dividends accrued. This aim is a long-term goal, acknowledging that management expects both higher and lower results in the shorter term. The cyclicality and volatility of the insurance market is expected to be the largest driver of this pattern. Management monitors these peaks and troughs – adjusting the Group's portfolio to make the most effective use of available capital and seeking to maximise the risk-adjusted return.

IRR achieved is as follows:

	Annual return %	Compound annual return %	Inception to date return %
31 December 2005[(1)]	(3.2)	n/a	(3.2)
31 December 2006	17.8	14.0	14.0
31 December 2007	31.4	22.4	50.3
31 December 2008	7.8	17.9	63.7
31 December 2009	26.5	19.8	105.8
31 December 2010	23.3	20.3	152.4
31 December 2011	13.4	19.5	191.2
31 December 2012	16.7	19.2	242.7

(1) The returns shown are for the period from the date of incorporation, 12 October 2005, to 31 December 2005.

IRR achieved in excess of the three-month treasury yield is as follows:

	Annual return %	Compound annual return %	Inception to date return %
31 December 2005[1]	(3.4)	n/a	(3.4)
31 December 2006	13.0	9.2	9.2
31 December 2007	26.9	17.8	40.8
31 December 2008	6.4	14.3	52.7
31 December 2009	26.4	17.1	94.6
31 December 2010	23.2	18.2	141.1
31 December 2011	13.3	17.7	179.9
31 December 2012	16.6	17.7	231.27

(1) The returns shown are for the period from the date of incorporation, 12 October 2005, to 31 December 2005.

iii. Retention risks

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;
- documented recruitment procedures, position descriptions and employment contracts; and
- resource monitoring and the provision of appropriate compensation, including equity based compensation which vests over a defined time horizon, and training schemes.

1. General information

The Group is a provider of global specialty insurance and reinsurance products. LHL was incorporated under the laws of Bermuda on 12 October 2005. On 16 March 2009 LHL was added to the official list and its common shares were admitted to trading on the main market of the LSE; previously LHL's shares were listed on AIM, a subsidiary market of the LSE. Since 21 May 2007 LHL's shares have had a secondary listing on the BSX. LHL's registered office is Power House, 7 Par-la-Ville Road, Hamilton HM 11, Bermuda. From 1 January 2012 LHL's head office is at Level 11, Vitro, 60 Fenchurch Street, London, EC3M 4AD, United Kingdom. As of 1 January 2012 LHL moved its tax residency from Bermuda to the UK. LHL expects to meet the conditions for the temporary period exemption from the UK's Controlled Foreign Company rules which were introduced by the UK Finance Act 2011, and has obtained comfort on this matter from HMRC.

LHL has six subsidiaries, all wholly owned: LICL, LIHL, LIMSL, LISL, LMSCL and SML. LIHL is a holding company for a wholly owned operating subsidiary, LUK.

The subsidiaries were incorporated on the following dates and as at 31 December 2012 held the following licence or authorisations as insurance companies or intermediaries:

	Date of incorporation	Licensing body	Nature of business
LICL	28 October 2005	BMA	General insurance business
LIHL	11 April 2006	None	Holding company
LUK	17 March 2006	FSA	General insurance business
LIMSL	7 October 2005	FSA	Insurance mediation activities
LISL	17 March 2006	None	Support services
LMSCL	16 May 2012	None	Support services
SML	30 October 2012	BMA	Insurance management services

2. Segmental reporting

Management and the Board of Directors review the Group's business primarily by its four principal classes: Property, Energy, Marine and Aviation. These classes are therefore deemed to be the Group's operating segments for the purposes of segment reporting. Further subclasses of business are underwritten within each operating segment. The nature of these individual subclasses is discussed further in the risk disclosures section on pages 83 to 85. Operating segment performance is measured by the net underwriting profit or loss and the combined ratio.

All amounts reported are transactions with external parties. There are no inter-segmental transactions and there are no significant insurance or reinsurance contracts that insure or reinsure risks in Bermuda, the Group's country of domicile.

Revenue and expense by operating segment

For the year ended 31 December 2012	Property $m	Energy $m	Marine $m	Aviation $m	Total $m
Gross premium written by geographical region					
Worldwide offshore	–	229.4	79.7	–	309.1
Worldwide, including the U.S. and Canada[(1)]	124.5	5.8	0.6	45.9	176.8
U.S. and Canada	84.5	2.5	–	–	87.0
Far East	40.5	0.9	–	–	41.4
Europe	39.1	0.1	0.1	–	39.3
Worldwide, excluding the U.S. and Canada[(2)]	24.4	1.1	–	–	25.5
Middle East	7.8	0.3	–	–	8.1
Rest of world	35.7	0.8	0.6	–	37.1
Total	**356.5**	**240.9**	**81.0**	**45.9**	**724.3**
Outwards reinsurance premiums	(97.1)	(26.7)	(20.5)	(3.9)	(148.2)
Change in unearned premiums	18.7	(8.1)	(7.2)	0.4	3.8
Change in unearned premiums ceded	1.0	1.7	–	–	2.7
Net premiums earned	**279.1**	**207.8**	**53.3**	**42.4**	**582.6**
Insurance losses and loss adjustment expenses	(109.1)	(24.0)	(81.8)	(2.0)	(216.9)
Insurance losses and loss adjustment expenses recoverable	(3.6)	(2.8)	49.2	–	42.8
Insurance acquisition expenses	(44.0)	(52.5)	(23.3)	(10.4)	(130.2)
Insurance acquisition expenses ceded	10.0	0.5	0.2	0.1	10.8
Net underwriting profit	**132.4**	**129.0**	**(2.4)**	**30.1**	**289.1**
Net unallocated income and expenses					(52.3)
Profit before tax					**236.8**
Net loss ratio	40.4%	12.9%	61.2%	4.7%	29.9%
Net acquisition cost ratio	12.2%	25.0%	43.3%	24.3%	20.5%
Expense ratio	–	–	–	–	13.5%
Combined ratio	**52.6%**	**37.9%**	**104.5%**	**29.0%**	**63.9%**

(1) Worldwide, including the U.S. and Canada, comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area.

(2) Worldwide, excluding the U.S. and Canada, comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area, but that specifically exclude the U.S. and Canada.

2. Segmental reporting continued

Revenue and expense by operating segment

For the year ended 31 December 2011	Property $m	Energy $m	Marine $m	Aviation $m	Total $m
Gross premium written by geographical region					
Worldwide offshore	0.6	210.0	73.7	–	284.3
Worldwide, including the U.S. and Canada(1)	59.4	11.6	1.3	47.1	119.4
U.S. and Canada	80.9	3.3	–	–	84.2
Far East	25.9	0.2	0.1	–	26.2
Europe	30.2	0.6	0.7	–	31.5
Worldwide, excluding the U.S. and Canada(2)	25.8	0.5	–	–	26.3
Middle East	7.7	0.8	–	–	8.5
Rest of world	49.3	2.0	0.6	–	51.9
Total	**279.8**	**229.0**	**76.4**	**47.1**	**632.3**
Outwards reinsurance premiums	(41.2)	(18.3)	(3.9)	(3.8)	(67.2)
Change in unearned premiums	12.0	(15.1)	4.8	1.8	3.5
Change in unearned premiums ceded	5.8	0.3	–	(0.2)	5.9
Net premiums earned	**256.4**	**195.9**	**77.3**	**44.9**	**574.5**
Insurance losses and loss adjustment expenses	(171.4)	(55.6)	(4.1)	5.8	(225.3)
Insurance losses and loss adjustment expenses recoverable	41.2	1.8	–	–	43.0
Insurance acquisition expenses	(36.3)	(43.0)	(25.1)	(9.8)	(114.2)
Insurance acquisition expenses ceded	1.2	0.4	0.1	0.1	1.8
Net underwriting profit	**91.1**	**99.5**	**48.2**	**41.0**	**279.8**
Net unallocated income and expenses					(61.2)
Profit before tax					**218.6**
Net loss ratio	50.8%	27.5%	5.3%	(12.9%)	31.7%
Net acquisition cost ratio	13.7%	21.7%	32.3%	21.6%	19.6%
Expense ratio	–	–	–	–	12.4%
Combined ratio	**64.5%**	**49.2%**	**37.6%**	**8.7%**	**63.7%**

(1) Worldwide, including the U.S. and Canada, comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area.

(2) Worldwide, excluding the U.S. and Canada, comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area, but that specifically exclude the U.S. and Canada.

3. Investment return

The total investment return for the Group is as follows:

For the year ended 31 December 2012	Investment income and other investment income $m	Net realised gains (losses) and impairments $m	Net change in unrealised gains /losses $m	Total investment return excluding foreign exchange $m	Foreign exchange gains (losses) $m	Total investment return including foreign exchange $m
Fixed income securities	32.2	13.4	18.1	63.7	0.7	64.4
Other investments	0.7	(1.6)	–	(0.9)	(1.7)	(2.6)
Cash and cash equivalents	0.3	–	–	0.3	–	0.3
Total investment return	**33.2**	**11.8**	**18.1**	**63.1**	**(1.0)**	**62.1**

For the year ended 31 December 2011	Investment income and other investment income $m	Net realised gains (losses) and impairments $m	Net change in unrealised gains /losses $m	Total investment return excluding foreign exchange $m	Foreign exchange gains (losses) $m	Total investment return including foreign exchange $m
Fixed income securities	41.2	16.0	(10.5)	46.7	(7.4)	39.3
Equity securities	1.1	(7.2)	–	(6.1)	–	(6.1)
Other investments	(0.5)	(0.2)	–	(0.7)	1.4	0.7
Cash and cash equivalents	0.9	–	–	0.9	–	0.9
Total investment return	**42.7**	**8.6**	**(10.5)**	**40.8**	**(6.0)**	**34.8**

Net realised gains (losses) and impairments includes impairment losses of $0.3 million (2011 – $0.3 million) recognised on fixed income securities held by the Group.

Refer to page 93 in the risk disclosures section for the estimated fair values of the Group's derivative instruments. Realised gains and losses on futures and options contracts are included in net realised gains (losses) and impairments. The net impact of TBAs is $nil for all reporting periods.

Included in investment income is $4.0 million (2011 – $4.3 million) of investment management, accounting and custodian fees.

4. Net insurance acquisition expenses

	2012 $m	2011 $m
Insurance acquisition expenses	136.8	114.4
Changes in deferred insurance acquisition expenses	(6.6)	(0.2)
Insurance acquisition expenses ceded	(10.9)	(2.4)
Changes in deferred insurance acquisition expenses ceded	0.1	0.6
Total net insurance acquisition expenses	**119.4**	**112.4**

5. Results of operating activities

Results of operating activities are stated after charging the following amounts:

	2012 $m	2011 $m
Depreciation on owned assets	2.8	2.9
Operating lease charges	2.3	1.8
Auditors' remuneration		
– Group audit fees	1.1	1.3
– Other services	0.3	0.1
Total	**6.5**	**6.1**

Fees paid to the Group's auditors for tax advice and other services are approved by the Group's Audit Committee.

6. Employee benefits

	2012 $m	2011 $m
Wages and salaries	19.1	19.3
Pension costs	1.9	1.8
Bonus and other benefits	25.9	19.7
Total cash compensation	**46.9**	**40.8**
RSS – ordinary	12.0	10.6
RSS – bonus deferral	4.2	4.1
LTIP	0.2	4.1
Total equity based compensation	**16.4**	**18.8**
Total employee benefits	**63.3**	**59.6**

Equity based compensation

The Group's primary equity based compensation scheme is its RSS. Previously the Group also issued options to employees pursuant to an LTIP, which has been closed to further issues, and also authorised and issued warrants at its formation in 2005 and 2006. Further details of the warrants can be found in note 22.

RSS

On 22 December 2010 LHL's shareholders, in a Special General Meeting, voted in favour of the LHL Board's proposal to modify the existing RSS awards programme to a nil-cost options programme. The modification introduced an exercise period of ten years from the grant date for all outstanding and future RSS grants. Previously, all awards were automatically converted to shares on the vesting date.

The fair value of any TSR component of the nil-cost options is estimated using a stochastic model. For all other components the Black-Scholes model is used to estimate the fair value.

The following table lists the assumptions used in the stochastic model for the RSS awards granted during the years ended 31 December 2012 and 2011:

Assumptions	2012	2011
Dividend yield	0.0%	0.0%
Expected volatility(1)	23.7% – 24.2%	22.1% – 24.9%
Risk-free interest rate(2)	0.50% – 0.53%	0.96% – 1.49%
Expected average life of options	3 years	3 years
Share price	$12.56 – $12.91	$9.67 – $11.14

(1) The expected volatility of LHL and comparator companies share prices are calculated based on the movement in the share prices over a period prior to the grant date, equal in length to the expected life of the award.

(2) The risk-free interest rate is consistent with UK government bond yields.

The calculation of the equity based compensation expense assumes forfeitures due to employee turnover of 10% per annum prior to vesting, with subsequent adjustments to reflect actual experience.

RSS – ordinary

The ordinary RSS options vest after a three-year period and are dependent on certain performance criteria. A maximum of 50% of the ordinary RSS options will vest only on the achievement of an LHL TSR in excess of the 75th percentile of the TSR of a predefined comparator group. A maximum of 50% of the ordinary RSS options will vest only on the achievement of an LHL RoE in excess of a required amount. An amount equivalent to the dividends paid between the grant date and the exercise date accrues and is paid at the time of exercise, pro-rata according to the number of RSS options that vest.

	Number of employee restricted stock	Number of Non-executive director restricted stock	Total number of restricted stock
Outstanding as at 31 December 2010	**5,905,445**	**–**	**5,905,445**
Granted	1,955,830	–	1,955,830
Exercised	(1,500,995)	–	(1,500,995)
Lapsed	(7,223)	–	(7,223)
Forfeited	(124,220)	–	(124,220)
Outstanding as at 31 December 2011	**6,228,837**	**–**	**6,228,837**
Granted	1,518,767	–	1,518,767
Exercised	(2,091,161)	–	(2,091,161)
Forfeited	(180,293)	–	(180,293)
Reclassified (1)	(561,327)	561,327	–
Outstanding as at 31 December 2012	**4,914,823**	**561,327**	**5,476,150**
Exercisable as at 31 December 2012	**1,915,163**	**–**	**1,915,163**

(1) On 30 June 2012 Neil McConachie relinquished his executive role but continued as a Board member in a non-executive capacity. His RSS options are shown separately from employee RSS options in the table above.

	2012			2011
	Employee restricted stock	Non-executive director restricted stock	Total restricted stock	Total restricted stock
Weighted average remaining contractual life	8.0 years	8.2 years	8.1 years	8.1 years
Weighted average fair value at date of grant during the year	$9.99	$9.98	$9.99	$7.98
Weighted average share price at date of exercise during the year	$12.24	–	$12.24	$10.53

Financial statements

6. Employee benefits continued

RSS – bonus deferral

The bonus deferral RSS options vesting periods range from one to three years and do not have associated performance criteria for vesting. An amount equivalent to the dividends paid between the grant date and the exercise date accrues and is paid at the time of exercise.

	Number of employee restricted stock	Number of Non-executive director restricted stock	Total number of restricted stock
Outstanding as at 31 December 2010	**371,834**	**–**	**371,834**
Granted	549,738	–	549,738
Forfeited	(4,417)	–	(4,417)
Outstanding as at 31 December 2011	**917,155**	**–**	**917,155**
Granted	234,454	–	234,454
Exercised	(386,542)	–	(386,542)
Forfeited	(4,085)	–	(4,085)
Reclassified(1)	(103,639)	103,639	–
Outstanding as at 31 December 2012	**657,343**	**103,639**	**760,982**
Exercisable as at 31 December 2012	**36,694**	**–**	**36,694**

(1) On 30 June 2012 Neil McConachie relinquished his executive role but continued as a Board member in a non-executive capacity. His RSS options are shown separately from employee RSS options in the table above.

	2012			2011
	Employee restricted stock	Non-executive director restricted stock	Total restricted stock	Total restricted stock
Weighted average remaining contractual life	8.3 years	8.4 years	8.3 years	8.8 years
Weighted average fair value at date of grant during the year	$12.31	$12.16	$12.30	$10.01
Weighted average share price at date of exercise during the year	$12.24	–	$12.24	–

LTIP

The LTIP plan was closed on 4 January 2008. All LTIP options will expire ten years from the date of grant. 25% of LTIP options vested on each of the first, second, third and fourth anniversary of the grant date. There were no associated performance criteria. Settlement is at the discretion of the Group and may be in cash or shares.

	Number	Weighted average exercise price
Outstanding as at 31 December 2010	**1,783,163**	**$2.88**
Exercised	(1,379,379)	$2.53
Forfeited	(66,720)	$2.32
Outstanding as at 31 December 2011	**337,064**	**$2.11**
Exercised	(203,228)	$2.17
Forfeited	–	–
Outstanding and exercisable as at 31 December 2012	**133,836**	**$0.98**

	2012	2011
Weighted average remaining contractual life	4.5 years	5.5 years
Weighted average share price at date of exercise during the year	$12.27	$10.61

As approved by the Remuneration Committee on 18 November 2009, all option exercise prices are automatically adjusted on the dividend record date to neutralise the devaluing impact of dividend payments. Prior to this date the Remuneration Committee met and approved each individual exercise price adjustment. The resulting charge to equity based compensation in the consolidated statement of comprehensive income is shown below. In all cases there is a net $nil impact to shareholders' equity.

Date	Adjustment to exercise price $	£	2012 $m	2011 $m
14 February 2008	1.10	0.56	–	0.1
4 November 2009	1.30	0.79	–	0.5
19 March 2010	0.10	0.07	–	0.1
3 September 2010	0.05	0.03	–	0.1
10 December 2010	1.40	0.89	–	2.5
18 March 2011	0.10	0.06	–	0.1
26 August 2011	0.05	0.03	–	–
25 November 2011	0.80	0.52	–	0.6
16 March 2012	0.10	0.06	–	–
31 August 2012	0.05	0.03	–	–
30 November 2012	0.90	0.56	0.2	–
Total			**0.2**	**4.0**

Management team ordinary warrants

Ordinary warrants were all fully vested by 31 December 2008. All ordinary warrants will expire ten years from the date of issue. The fair value of all ordinary warrants granted was $2.62 per warrant. Ordinary warrants granted and outstanding are:

	Number	Weighted average exercise price
Outstanding as at 31 December 2010	**10,034,795**	**$4.72**
Exercised	(1,169,766)	$4.62
Sale to external buyer	(2,350,000)	$5.00
Outstanding as at 31 December 2011	**6,515,029**	**$4.65**
Exercised	(330,630)	$4.84
Outstanding and exercisable as at 31 December 2012	**6,184,399**	**$4.64**

	2012	2011
Weighted average remaining contractual life	3.0 years	4.0 years
Weighted average share price at date of exercise during the year	$13.03	$10.80

Refer to note 25 for further disclosure on the warrants sale.

Management team performance warrants

Performance warrants were all fully vested by 31 December 2009. All performance warrants will expire ten years from the date of issue. Vesting was dependent on achieving certain performance criteria. The fair value of all warrants granted was $2.62 per warrant. The exercise price of warrants was automatically adjusted for dividends declared prior to their vesting dates.

6. Employee benefits continued

Performance warrants granted and outstanding are:

	Number	Weighted average exercise price
Outstanding as at 31 December 2010	**1,344,810**	**$3.62**
Exercised	(417,494)	$3.61
Outstanding as at 31 December 2011	**927,316**	**$3.62**
Exercised	(67,871)	$3.63
Outstanding and exercisable as at 31 December 2012	**859,445**	**$3.62**

	2012	2011
Weighted average remaining contractual life	3.0 years	4.0 years
Weighted average share price at date of exercise during the year	$13.52	$11.09

Refer to note 22 for further disclosure on non-management warrants outstanding.

7. Financing costs

	2012 $m	2011 $m
Interest expense on long-term debt	7.2	5.6
Net losses on interest rate swaps	4.1	7.4
Other financing costs	3.2	1.2
Total	**14.5**	**14.2**

Refer to note 20 for details of long-term debt and financing arrangements.

8. Tax charge

Bermuda

LHL, LICL and LUK have received an undertaking from the Bermuda government exempting them from all Bermuda local income, withholding and capital gains taxes until 28 March 2035. At the present time no such taxes are levied in Bermuda.

United States

The Group does not consider itself to be engaged in trade or business in the U.S. and, accordingly, does not expect to be subject to U.S. taxation on its income or capital gains.

United Kingdom

LHL and the UK subsidiaries are subject to normal UK corporation tax on all their taxable profits.

Tax charge	2012 $m	2011 $m
Current tax charge for the period	1.1	6.0
Adjustments in respect of prior period corporation tax	(0.3)	(0.1)
Deferred tax charge for the period	0.7	0.5
Adjustments in respect of prior period deferred tax	0.4	–
Total tax charge	**1.9**	**6.4**

Tax reconciliation	2012 $m	2011 $m
Profit before tax	236.8	218.6
Less loss (profit) not subject to tax	2.8	(196.6)
Profits subject to tax	**239.6**	**22.0**
UK corporation tax at 24.5% (26.5%)	58.7	5.8
Non-taxable income	(73.6)	–
Adjustments in respect of prior period	0.1	(0.1)
Differences related to equity based compensation	1.6	(0.1)
Other expense permanent differences	9.0	0.1
Tax rate change adjustment	0.6	0.7
Unused tax losses not recognised for deferred tax	5.5	–
Total tax charge	**1.9**	**6.4**

Due to the different taxpaying jurisdictions throughout the Group the current tax charge as a percentage of the Group's profit before tax is 0.8% (2011 – 2.9%). Following the move of its tax residency to the UK on 1 January 2012, the ultimate parent undertaking's profits before tax are included within profits subject to tax for the first time in 2012. Dividend income from its subsidiary companies is, however, exempt from UK corporation tax and therefore appears as a reconciling item as non-taxable income.

A corporation tax credit of $1.4 million (2011 – $2.0 million) was recognised in other reserves which relates to tax deductions for equity based compensation award exercises in excess of the cumulative expense at the reporting date. Refer to note 15 for further details of tax credits included in other reserves.

Refer to note 10 for details of the tax expense related to the net change in unrealised gains/losses on investments that is included in accumulated other comprehensive income within shareholders' equity.

9. Cash and cash equivalents

	2012 $m	2011 $m
Cash at bank and in hand	209.4	122.9
Cash equivalents	86.4	188.9
Total cash and cash equivalents	**295.8**	**311.8**

Cash equivalents have an original maturity of three months or less. The carrying amount of these assets approximates their fair value. Refer to note 20 for the cash and cash equivalent balances on deposit as collateral.

10. Investments

As at 31 December 2012	Cost or amortised cost $m	Gross unrealised gain $m	Gross unrealised loss $m	Estimated fair value $m
Fixed income securities				
– Short-term investments	114.8	–	–	114.8
– U.S. treasuries	214.5	0.5	(0.1)	214.9
– Other government bonds	145.0	7.0	(1.1)	150.9
– U.S. municipal bonds	26.7	2.0	(0.1)	28.6
– U.S. government agency debt	130.4	1.2	–	131.6
– Asset backed securities	73.0	0.9	–	73.9
– U.S. government agency mortgage backed securities	394.1	9.2	(0.2)	403.1
– Non-agency mortgage backed securities	8.3	0.2	–	8.5
– Agency commercial mortgage backed securities	1.6	–	–	1.6
– Non-agency commercial mortgage backed securities	27.0	2.6	–	29.6
– Bank loans	37.4	0.1	(0.1)	37.4
– Corporate bonds	665.5	14.6	(0.5)	679.6
Total fixed income securities	**1,838.3**	**38.3**	**(2.1)**	**1,874.5**
Other investments	(0.2)	0.7	(0.4)	0.1
Total investments	**1,838.1**	**39.0**	**(2.5)**	**1,874.6**

As at 31 December 2011	Cost or amortised cost $m	Gross unrealised gain $m	Gross unrealised loss $m	Estimated fair value $m
Fixed income securities				
– Short-term investments	78.9	–	–	78.9
– U.S. treasuries	349.7	1.4	–	351.1
– Other government bonds	158.6	2.8	(2.3)	159.1
– U.S. municipal bonds	26.8	1.0	(0.1)	27.7
– U.S. government agency debt	82.5	0.5	–	83.0
– Asset backed securities	69.9	0.2	(0.5)	69.6
– U.S. government agency mortgage backed securities	251.8	8.6	(0.1)	260.3
– Non-agency mortgage backed securities	13.1	0.1	(0.1)	13.1
– Non-agency commercial mortgage backed securities	30.2	1.3	–	31.5
– Corporate bonds	587.0	10.4	(6.9)	590.5
– Corporate bonds – FDIC guaranteed	48.8	0.4	–	49.2
Total fixed income securities	**1,697.3**	**26.7**	**(10.0)**	**1,714.0**
Other investments	(0.3)	2.6	(2.9)	(0.6)
Total investments	**1,697.0**	**29.3**	**(12.9)**	**1,713.4**

Accumulated other comprehensive income is in relation to the Group's fixed income securities and is as follows:

	2012 $m	2011 $m
Gross unrealised gains	38.3	26.7
Gross unrealised losses	(2.1)	(10.0)
Net foreign exchange losses (gains)	0.3	1.7
Tax provision	(1.1)	(0.8)
Accumulated other comprehensive income	**35.4**	**17.6**

Fixed income maturities are presented in the risk disclosures section on page 99. Refer to note 20 for the investment balances in trusts in favour of ceding companies and on deposit as collateral.

The fair value of securities in the Group's investment portfolio is estimated using the following techniques:

Category (i)
Category (i) includes securities with quoted prices in active markets. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arm's length basis. The Group determines securities classified as category (i) to include highly liquid U.S. treasuries and certain highly liquid short-term investments.

Category (ii)
Category (ii) investments include securities with quoted prices in active markets for similar assets or liabilities or other valuation techniques for which all significant inputs are based on observable market data. Instruments included in category (ii) are valued via independent external sources using modeled or other valuation methods. Such methods are typically industry accepted standard and include:

– broker-dealer quotes;
– pricing models or matrix pricing;
– present values;
– future cash flows;
– yield curves;
– interest rates;
– prepayment speeds; and
– default rates.

Other similar quoted instruments or market transactions may be used.

The Group determines securities classified as category (ii) to include short-term and fixed maturity investments such as:

– Non-U.S. government bonds;
– U.S. municipal bonds;
– U.S. government agency debt;
– Asset backed securities;
– U.S. government agency mortgage backed securities;
– Non-agency mortgage backed securities;
– Corporate bonds; and
– OTC derivatives, including futures, options, forward foreign exchange contracts, interest rate swaps, credit default swaps and swaptions.

10. Investments continued

Category (iii)

Category (iii) includes securities for which valuation techniques are not based on observable market data. During the years ended 31 December 2012 and 2011, the Group did not hold any category (iii) investments.

The Group determines the estimated fair value of each individual security utilising the highest level inputs available. Prices for the Group'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. The audit reports are available to clients of the firm and the report is reviewed annually by management. In accordance with their pricing policy, various recognised reputable pricing sources are used including index providers, 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' and custodian's pricing.

The Group has not made any adjustments to any pricing provided by independent pricing services or its third party investment managers for either year ending 31 December.

The fair value hierarchy of the Group's investment holdings is as follows:

As at 31 December 2012	(i) $m	(ii) $m	Total $m
Fixed income securities			
– Short-term investments	114.6	0.2	114.8
– U.S. treasuries	214.9	–	214.9
– Other government bonds	–	150.9	150.9
– U.S. municipal bonds	–	28.6	28.6
– U.S. government agency debt	–	131.6	131.6
– Asset backed securities	–	73.9	73.9
– U.S. government agency mortgage backed securities	–	403.1	403.1
– Non-agency mortgage backed securities	–	8.5	8.5
– Agency commercial mortgage backed securities	–	1.6	1.6
– Non-agency commercial mortgage backed securities	–	29.6	29.6
– Bank loans	–	37.4	37.4
– Corporate bonds	–	679.6	679.6
Total fixed income securities	**329.5**	**1,545.0**	**1,874.5**
Other investments	–	0.1	0.1
Total investments	**329.5**	**1,545.1**	**1,874.6**

As at 31 December 2011	(i) $m	(ii) $m	Total $m
Fixed income securities			
– Short-term investments	72.1	6.8	78.9
– U.S. treasuries	351.1	–	351.1
– Other government bonds	–	159.1	159.1
– U.S. municipal bonds	–	27.7	27.7
– U.S. government agency debt	–	83.0	83.0
– Asset backed securities	–	69.6	69.6
– U.S. government agency mortgage backed securities	–	260.3	260.3
– Non-agency mortgage backed securities	–	13.1	13.1
– Non-agency commercial mortgage backed securities	–	31.5	31.5
– Corporate bonds	–	590.5	590.5
– Corporate bonds – FDIC guaranteed	–	49.2	49.2
Total fixed income securities	**423.2**	**1,290.8**	**1,714.0**
Other investments	–	(0.6)	(0.6)
Total investments	**423.2**	**1,290.2**	**1,713.4**

There have been no transfers between categories (i) and (ii) or movements within category (iii), therefore no reconciliations have been presented.

11. Reinsurance assets and liabilities

	Unearned premiums ceded $m	Amounts payable to reinsurers $m	Other receivables $m	Total $m
As at 31 December 2010	**2.9**	**(4.4)**	**5.6**	**4.1**
Net deferral for prior years	(2.9)	–	–	(2.9)
Net deferral for current year	8.8	–	–	8.8
Other	–	(13.4)	0.6	(12.8)
As at 31 December 2011	**8.8**	**(17.8)**	**6.2**	**(2.8)**
Net deferral for prior years	(8.8)	–	–	(8.8)
Net deferral for current year	11.5	–	–	11.5
Other	–	(12.8)	(1.7)	(14.5)
As at 31 December 2012	**11.5**	**(30.6)**	**4.5**	**(14.6)**

12. Losses and loss adjustment expenses

	Losses and loss adjustment expenses $m	Reinsurance recoveries $m	Net losses and loss adjustment expenses $m
As at 31 December 2010	**507.5**	**(35.9)**	**471.6**
Net incurred losses for:			
Prior years	(168.5)	13.2	(155.3)
Current year	393.8	(56.2)	337.6
Exchange adjustments	2.5	–	2.5
Incurred losses and loss adjustment expenses	**227.8**	**(43.0)**	**184.8**
Net paid losses for:			
Prior years	130.2	(9.2)	121.0
Current year	33.9	–	33.9
Paid losses and loss adjustment expenses	**164.1**	**(9.2)**	**154.9**
As at 31 December 2011	**571.2**	**(69.7)**	**501.5**
Net incurred losses for:			
Prior years	(33.5)	6.1	(27.4)
Current year	250.4	(48.9)	201.5
Exchange adjustments	(11.2)	–	(11.2)
Incurred losses and loss adjustment expenses	**205.7**	**(42.8)**	**162.9**
Net paid losses for:			
Prior years	134.4	(8.2)	126.2
Current year	105.1	(31.3)	73.8
Paid losses and loss adjustment expenses	**239.5**	**(39.5)**	**200.0**
As at 31 December 2012	**537.4**	**(73.0)**	**464.4**

Further information on the calculation of loss reserves and the risks associated with them is provided in the risk disclosures section from page 86. The risks associated with general insurance contracts are complex and do not readily lend themselves to meaningful sensitivity analysis. The impact of an unreported event could lead to a significant increase in our loss reserves. The Group believes that the loss reserves established are adequate, however a 20% increase in estimated losses would lead to a $107.5 million (2011 – $114.2 million) increase in loss reserves. There was no change to the Group's reserving methodology during the year. The split of losses and loss adjustment expenses between notified outstanding losses, additional case reserves assessed by management and IBNR is shown below:

	2012		2011	
As at 31 December	$m	%	$m	%
Outstanding losses	306.2	57.0	276.7	48.4
Additional case reserves	98.3	18.3	123.9	21.7
Losses incurred but not reported	132.9	24.7	170.6	29.9
Total	**537.4**	**100.0**	**571.2**	**100.0**

The Group's reserve for unpaid losses and loss adjustment expenses as at 31 December 2012 and 2011 had an estimated duration of approximately two years.

Claims development

The development of insurance liabilities is indicative of the Group's ability to estimate the ultimate value of its insurance liabilities. The Group began writing insurance and reinsurance business in December 2005. Due to the minimal number of underlying risks and lack of known loss events occurring during the period to 31 December 2005, the Group does not expect to incur any losses from coverage provided in 2005. Accordingly, the loss development tables do not include that year.

Accident year	2006 $m	2007 $m	2008 $m	2009 $m	2010 $m	2011 $m	2012 $m	Total $m
Gross losses								
Estimate of ultimate liability(1)								
At end of accident year	39.1	154.8	444.6	163.3	297.4	397.0	250.3	
One year later	34.7	131.2	417.4	107.8	209.4	371.9		
Two years later	32.0	103.5	377.5	73.1	204.2			
Three years later	27.6	94.8	345.1	66.0				
Four years later	27.2	83.5	340.8					
Five years later	24.4	81.0						
Six years later	24.0							
Current estimate of cumulative liability	**24.0**	**81.0**	**340.8**	**66.0**	**204.2**	**371.9**	**250.3**	**1,338.2**
Payments made	**(22.1)**	**(74.5)**	**(306.1)**	**(46.7)**	**(133.1)**	**(113.2)**	**(105.1)**	**(800.8)**
Total gross liability	**1.9**	**6.5**	**34.7**	**19.3**	**71.1**	**258.7**	**145.2**	**537.4**

(1) Adjusted for revaluation of foreign currencies at the exchange rate as at 31 December 2012.

Accident year	2006 $m	2007 $m	2008 $m	2009 $m	2010 $m	2011 $m	2012 $m	Total $m
Reinsurance								
Estimate of ultimate recovery(1)								
At end of accident year	–	3.6	40.7	1.6	33.8	56.2	48.9	
One year later	–	6.2	47.1	1.3	23.6	52.6		
Two years later	–	4.0	43.1	0.7	24.1			
Three years later	–	3.5	40.9	0.7				
Four years later	–	3.3	38.1					
Five years later	–	3.1						
Six years later	–							
Current estimate of cumulative recovery	**–**	**3.1**	**38.1**	**0.7**	**24.1**	**52.6**	**48.9**	**167.5**
Payments made	**–**	**(3.1)**	**(33.7)**	**(0.7)**	**(22.6)**	**(3.1)**	**(31.3)**	**(94.5)**
Total gross recovery	**–**	**–**	**4.4**	**–**	**1.5**	**49.5**	**17.6**	**73.0**

(1) Adjusted for revaluation of foreign currencies at the exchange rate as at 31 December 2012.

12. Losses and loss adjustment expenses continued

Accident year	2006 $m	2007 $m	2008 $m	2009 $m	2010 $m	2011 $m	2012 $m	Total $m
Net losses								
Estimate of ultimate liability(1)								
At end of accident year	39.1	151.2	403.9	161.7	263.6	340.8	201.4	
One year later	34.7	125.0	370.3	106.5	185.8	319.3		
Two years later	32.0	99.5	334.4	72.4	180.1			
Three years later	27.6	91.3	304.2	65.3				
Four years later	27.2	80.2	302.7					
Five years later	24.4	77.9						
Six years later	24.0							
Current estimate of cumulative liability	**24.0**	**77.9**	**302.7**	**65.3**	**180.1**	**319.3**	**201.4**	**1,170.7**
Payments made	**(22.1)**	**(71.4)**	**(272.4)**	**(46.0)**	**(110.5)**	**(110.1)**	**(73.8)**	**(706.3)**
Total net liability	**1.9**	**6.5**	**30.3**	**19.3**	**69.6**	**209.2**	**127.6**	**464.4**

(1) Adjusted for revaluation of foreign currencies at the exchange rate as at 31 December 2012.

The inherent uncertainty in reserving gives rise to favourable or adverse development on the established reserves. The total favourable development on net losses and loss adjustment expenses, excluding the impact of foreign exchange revaluations, was as follows:

	2012 $m	2011 $m
2006 accident year	0.4	2.9
2007 accident year	2.3	11.1
2008 accident year	1.7	29.8
2009 accident year	7.1	33.7
2010 accident year	6.4	77.8
2011 accident year	9.5	–
Total favourable development	**27.4**	**155.3**

The favourable prior year development in 2012 arose primarily from IBNR releases due to fewer than expected reported losses offset to an extent by unfavourable development on various outstanding case reserves and additional case reserves as a result of updated information received. In early 2011 an independent external reserve study was commissioned in order to incorporate the Group's own loss experience with the industry factors previously used. On completion net reserves of $36.9 million were released. The remaining favourable prior year development in 2011 arose primarily from further IBNR releases of $96.2 million due to fewer than expected reported losses plus net releases on outstanding case reserves and additional case reserves of $22.2 million as a result of updated information received.

During 2012 the Group was impacted by significant losses in relation to Sandy. Management's current best estimate of the ultimate net loss in relation to this event is $44.5 million. The 90th percentile of the loss distribution for this estimate is $53.3 million with the 95th percentile being $56.3 million. Significant uncertainty exists on the eventual ultimate loss.

During 2011 the Group was impacted by significant losses in relation to the Japan Tohoku earthquake and following tsunami. Management's current best estimate of the ultimate net loss in relation to this event is $119.0 million. The 90th percentile of the loss distribution for this estimate is $131.5 million with the 95th percentile being $135.8 million. Significant uncertainty exists on the eventual ultimate losses in relation to this event.

The Group's estimated ultimate net losses, after reinstatement premiums, for these significant events are as follows:

	Sandy $m	Japan $m
Net ultimate losses as at 31 December 2010	**–**	**–**
Change in insurance losses and loss adjustment expenses	–	119.2
Change in insurance losses and loss adjustment expenses recoverable	–	–
Change in reinstatement premium	–	(1.9)
Net ultimate losses as at 31 December 2011	**–**	**117.3**
Change in insurance losses and loss adjustment expenses	46.0	3.7
Change in insurance losses and loss adjustment expenses recoverable	–	–
Change in reinstatement premium	(1.5)	(2.0)
Net ultimate losses as at 31 December 2012	**44.5**	**119.0**

13. Insurance, reinsurance and other receivables

All receivables are considered current other than $37.2 million (2011 – $28.0 million) of inwards premiums receivable related to multi-year contracts. The carrying value approximates fair value due to the short-term nature of the receivables. There are no significant concentrations of credit risk within the Group's receivables.

14. Deferred acquisition costs and deferred acquisition costs ceded

The reconciliation between opening and closing deferred acquisition costs incurred and ceded is shown below:

	Incurred $m	Ceded $m	Net $m
As at 31 December 2010	**61.2**	**(0.1)**	**61.1**
Net deferral during the year	114.4	(2.4)	112.0
Income (expense) for the year	(114.2)	1.8	(112.4)
As at 31 December 2011	**61.4**	**(0.7)**	**60.7**
Net deferral during the year	136.8	(10.9)	125.9
Income (expense) for the year	(130.2)	10.8	(119.4)
As at 31 December 2012	**68.0**	**(0.8)**	**67.2**

15. Deferred tax asset

	2012 $m	2011 $m
Deferred tax assets (related to equity based compensation)	9.5	10.1
Deferred tax liabilities (related to claims equalisation reserves)	(2.2)	(1.9)
Net deferred tax asset	**7.3**	**8.2**

A deferred tax credit of $0.2 million (2011 – $2.4 million) was recognised in other reserves which relates to deferred tax credits for unexercised equity based compensation awards where the estimated market value is in excess of the cumulative expense at the reporting date.

Deferred tax assets are recognised to the extent that realising the related tax benefit through future taxable profits is likely. It is anticipated that sufficient taxable profits will be available within the Lancashire UK group of companies in 2013 and subsequent years to utilise the deferred tax assets recognised when the underlying temporary differences reverse.

A deferred tax asset has not been recognised in relation to unused tax losses carried forward in the ultimate parent undertaking, as at present, the related tax benefit is not expected to be realised through future taxable profits.

The UK government has announced its intent to legislate to reduce the rate of corporation tax to 21.0% with effect from 1 April 2014. It is estimated that the effect of these changes will be to reduce the company's deferred tax asset by approximately $0.6 million.

All deferred tax assets and liabilities are classified as non-current.

16. Investment in associates

AHL

The Group has a commitment of up to $50.0 million representing a 20% interest in AHL, a company incorporated in Bermuda. AHL's operating subsidiary, ARL, is authorised as a Special Purpose Insurer by the BMA.

ARL assumes worldwide property retrocession risks from LICL. AHL is an unquoted investment and its shares do not trade on an active market. As at 31 December 2012 41.1 million of the commitment had been called. As at 31 December 2012 the carrying value of the Group's investment in AHL is $49.7 million (31 December 2011 – $50.9 million). The Group's share of comprehensive income for AHL for the period was $7.7 million (2011 – $0.9 million). Investments in associates are generally deemed non-current. Key financial information for AHL is as follows:

	2012 $m	2011[1] $m
Assets	272.5	260.1
Liabilities	26.0	5.8
Shareholders' equity	246.5	39.1
Amounts advanced in respect of shares to be issued	–	215.2
Gross premiums earned	66.6	6.6
Comprehensive income	36.7	4.3

(1) From the date of incorporation, 1 June 2011, to 31 December 2011.

Refer to note 25 for details of transactions between the Group, AHL and ARL.

SHL

In 2012 the Group invested $32.4 million representing a 20% interest in the common shares of SHL, a company incorporated in Bermuda. SHL's operating subsidiary, SRL, is authorised as a Special Purpose Insurer by the BMA. SRL is a market facing vehicle underwriting a combined exposure ultimate net loss aggregate reinsurance product. SRL commenced writing insurance business at 1 January 2013. Subsequent to year end $22.9 million of capital was returned by SHL to the Group. See note 28 for details. Financial information for the period from the date of incorporation, 29 October 2012, to 31 December 2012 is as follows:

	$m
Assets	192.3
Shareholders' equity	192.3

17. Property, plant and equipment

	2012 $m	2011 $m
Cost	12.9	12.6
Accumulated depreciation	(10.1)	(7.3)
Net book value	**2.8**	**5.3**

18. Insurance liabilities

	Unearned premiums $m	Other payables $m	Total $m
As at 31 December 2010	**350.6**	**20.6**	**371.2**
Net deferral for prior years	(273.3)	–	(273.3)
Net deferral for current year	269.8	–	269.8
Other	–	2.9	2.9
As at 31 December 2011	**347.1**	**23.5**	**370.6**
Net deferral for prior years	(271.4)	–	(271.4)
Net deferral for current year	267.6	–	267.6
As at 31 December 2012	**343.3**	**23.5**	**366.8**

19. Insurance, reinsurance and other payables

	2012 $m	2011 $m
Other payables	47.4	84.9
Accrued interest payable	1.9	0.3
Total other payables	**49.3**	**85.2**
Insurance contracts – other payables	23.5	23.5
Amounts payable to reinsurers	30.6	17.8
Total payables	**103.4**	**126.5**

Other payables include unsettled investment trades, accrued interest and other accruals. Insurance payables relate to amounts due to policyholders for profit commission, return premiums and claims payable. All payables are considered current. The carrying value approximates fair value due to the short-term nature of the payables.

20. Long-term debt and financing arrangements

Long-term debt

On 5 October 2012 the Group launched and priced an offering of U.S. $130 million 5.70% senior unsecured notes due 2022 pursuant to a private offering to U.S. Qualified Institutional Buyers. Interest on the principal is payable semi-annually. The notes were listed and admitted to trading on the LSE on 16 October 2012.

On 15 December 2005 the Group issued $97.0 million and €24.0 million in aggregate principal amount of subordinated loan notes at an issue price of $1,000 and €1,000 of their principal amounts respectively. The U.S. dollar subordinated loan notes are repayable on 15 December 2035 with a prepayment option available from 15 March 2011. Interest on the principal is based on a set margin, 3.70%, above the variable LIBOR rate and is payable quarterly. The loan notes were issued via a trust company. The Euro subordinated loan notes are repayable on 15 June 2035 with a prepayment option available from 15 March 2011. Interest on the principal is based on a set margin, 3.70%, above the variable Euribor rate and is payable quarterly. On 21 October 2011 the Cayman Islands Stock Exchange admitted to the official list the Group's U.S. dollar and Euro subordinated loan notes due 15 June 2035.

The carrying values of the notes are shown below:

As at 31 December	2012 $m	2011 $m
Long-term debt $130.0 million	130.0	–
Long-term debt $97.0 million	97.0	97.0
Long-term debt €24.0 million	31.7	31.0
Carrying value	**258.7**	**128.0**

The Group is exposed to cash flow interest rate risk and currency risk on its long-term debt. Further information is provided in the risk disclosures section on pages 96 and 97.

The fair value of the long-term debt is estimated as $252.9 million (2011 – $108.4 million). The fair value is estimated by reference to similar financial instruments quoted in active markets.

The interest accrued on the long-term debt was $1.9 million (2011 – $0.3 million) at the balance sheet date and is included in other payables.

Refer to note 7 for details of the interest expense for the year included in financing costs.

20. Long-term debt and financing arrangements continued

Interest rate swaps

The Group hedges a portion of its floating rate borrowings using interest rate swaps to transfer floating to fixed rate. These instruments are held at estimated fair value. Refer to the risk disclosures section from page 96 for further details. The Group has the right to net settle these instruments.

The net fair value position owed by the Group on the swap agreements is $8.0 million. Further information is provided on pages 93 and 96. The Group has the right to net settle these instruments. Cash settlements are completed on a quarterly basis and the total of the next cash settlement on these instruments is $0.6 million. The net impact from cash settlement and changes in estimated fair value is included in financing costs.

The interest rate swaps are held at estimated fair value, priced using observable market inputs, and are therefore classified as category (ii) securities in the fair value hierarchy.

Refer to note 7 for the net impact from cash settlement and changes in estimated fair value included in financing costs.

Letters of credit

As both LICL and LUK are non-admitted insurers or reinsurers throughout the U.S., the terms of certain contracts require them to provide LOCs to policyholders as collateral. LHL and LICL have the following facilities in place as of 31 December 2012:

(i) a $350.0 million syndicated collateralised credit facility with $75.0 million loan sub-limit that has been in place since 5 April 2012 and will expire on 5 April 2017. There was no outstanding debt under this facility at 31 December 2012; and

(ii) a $400.0 million bi-lateral uncommitted LOC facility with Citibank Europe PLC.

The facilities are available for the issue of LOCs to ceding companies. The facilities are also available for LICL to issue LOCs to LUK to collateralise certain insurance balances.

The Group's $200.0 million bi-lateral collateralised credit facility with Lloyds TSB Bank PLC and the Group's $200.0 million syndicated collateralised credit facility were terminated on 5 April 2012.

The terms of the $350.0 million LOC facility include standard default and cross default provisions which require certain covenants to be adhered to. These include the following:

(i) an A.M. Best financial strength rating of at least B++; and

(ii) a maximum debt to capital ratio of 30%, where the subordinated loan notes due in 2035 are excluded from this calculation.

As at all reporting dates the Group was in compliance with all covenants under these facilities. The $400.0 million bi-lateral uncommitted LOC facility does not contain default provisions or covenants.

The following LOCs have been issued:

As at 31 December	2012 $m	2011 $m
Issued to third parties	17.2	9.4

Letters of credit are required to be fully collateralised.

Trusts

The Group has several trust arrangements in place in favour of policyholders and ceding companies in order to comply with the security requirements of certain reinsurance contracts and/or the regulatory requirements of certain jurisdictions.

On 5 December 2012 LICL was approved as a Trusteed Reinsurer in the state of New York and established an MBRT to collateralise its insurance and reinsurance liabilities associated with U.S. domiciled clients. The MBRT is subject to the rules and regulations of the state of New York and the respective deed of trust. These rules and regulations include minimum capital funding requirements, investment guidelines, capital distribution restrictions and regulatory reporting requirements.

As at and for the years ended 31 December 2012 and 2011 the Group was in compliance with all covenants under its trust facilities.

The following cash and cash equivalents and investment balances were held in trust and other collateral accounts in favour of third parties:

	2012		2011	
As at 31 December	Cash and cash equivalents $m	Fixed income securities $m	Cash and cash equivalents $m	Fixed income securities $m
MBRT accounts	–	20.2	–	–
In various other trust accounts for policyholders	12.5	123.6	14.6	166.0
In favour of letters of credit	3.3	17.0	0.3	10.3
In favour of derivative contracts	–	0.4	0.9	0.5
Total	**15.8**	**161.2**	**15.8**	**176.8**

21. Share capital

Allocated, called up and fully paid	Number	$m
As at 31 December 2010, 2011 and 2012	**168,602,427**	**84.3**

Own shares	Number held in treasury	$m	Number held in trust	$m	Total number of own shares	$m
As at 31 December 2010	**15,448,445**	**100.2**	**736,025**	**6.7**	**16,184,470**	**106.9**
Shares distributed	(906,696)	(5.6)	(3,497,027)	(33.7)	(4,403,723)	(39.3)
Shares donated to trust	(4,028,423)	(25.4)	4,028,423	40.8	–	15.4
As at 31 December 2011	**10,513,326**	**69.2**	**1,267,421**	**13.8**	**11,780,747**	**83.0**
Shares distributed	(1,801,510)	(11.1)	(2,848,168)	(33.2)	(4,649,678)	(44.3)
Shares donated to trust	(2,901,233)	(17.4)	2,901,233	35.8	–	18.4
As at 31 December 2012	**5,810,583**	**40.7**	**1,320,486**	**16.4**	**7,131,069**	**57.1**

The number of common shares in issue with voting rights (allocated share capital less shares held in treasury) as at 31 December 2012 was 162,791,844 (31 December 2011 – 158,089,101).

Share repurchases

At the AGM held on 3 May 2012 the Group's shareholders approved a renewal of the Repurchase Programme authorising the repurchase of a maximum of 16,860,242 shares, with such authority to expire on the conclusion of the 2013 AGM or, if earlier, fifteen months from the date the resolution approving the Repurchase Programme was passed.

The Group has not utilised its Repurchase Programme since 16 September 2010. As at all reporting periods the maximum number of shares under the Group's Repurchase Programme remained to be purchased and no amounts remained to be settled.

In 2012 the trustees of the EBT acquired nil shares (2011 – nil) in accordance with the terms of the trust and distributed 2,848,168 (2011 – 3,497,027). There were no unsettled balances in relation to EBT purchases at either balance sheet date.

21. Share capital continued

Dividends

The Board of Directors have authorised the following dividends:

Type	Per share amount	Record date	Payment date	$m
Special	$1.40	10 Dec 2010	19 Jan 2011	264.0
Final	$0.10	18 Mar 2011	20 Apr 2011	18.9
Interim	$0.05	26 Aug 2011	28 Sep 2011	9.5
Special	$0.80	25 Nov 2011	15 Dec 2011	152.0
Final	$0.10	16 Mar 2012	18 Apr 2012	19.2
Interim	$0.05	30 Aug 2012	26 Sep 2012	9.6
Special	$0.90	30 Nov 2012	19 Dec 2012	172.6

22. Other reserves

Other reserves represent the Group's restricted shares, options and warrants. Changes in the number of restricted shares, options and management warrants held by employees are disclosed in note 6. The changes in the number of warrants held by non-employees are as follows:

	Number of Founder warrants	Number of Lancashire Foundation warrants	Number of ordinary warrants
Outstanding at 31 December 2010	**24,470,717**	**648,143**	**–**
Exercised	(1,710,497)	–	–
Sale to external buyer	–	–	2,350,000
Outstanding and exercisable as at 31 December 2011	**22,760,220**	**648,143**	**2,350,000**
Exercised	(2,956,648)	–	–
Outstanding and exercisable as at 31 December 2012	**19,803,572**	**648,143**	**2,350,000**
Weighted average exercise price as at 31 December 2012	**$5.00**	**$4.73**	**$5.00**

	2012	2011
Weighted average remaining contractual life	3.0 years	4.0 years
Weighted average share price at date of exercise during the year	$12.47	$10.64

The fair value of all warrants granted was $2.62 per warrant. The exercise price of the Lancashire Foundation warrants was automatically adjusted for dividends declared prior to the vesting date. Refer to note 6 for further details. This did not apply to the Founder warrants as they were fully vested at the date of grant and exercisable upon issuance.

Refer to note 25 for further disclosure on the 2,350,000 ordinary warrants sold to an external buyer.

23. Lease commitments

The Group has payment obligations in respect of operating leases for certain items of office equipment and office space. Operating lease expenses for the year were $2.3 million (2011 – $1.8 million). Future minimum lease payments under non-cancellable operating leases are as follows:

	2012 $m	2011 $m
Due in less than one year	2.5	2.4
Due between one and five years	3.4	5.6
Total	**5.9**	**8.0**

24. Earnings per share

The following reflects the profit and share data used in the basic and diluted earnings per share computations:

	2012 $m	2011 $m
Profit for the year attributable to equity shareholders	234.9	212.2

	2012 Number of shares	2011 Number of shares
Basic weighted average number of shares	159,575,802	154,339,421
Dilutive effect of RSS	4,278,094	5,088,005
Dilutive effect of LTIP	123,444	269,355
Dilutive effect of warrants	18,194,380	17,754,552
Diluted weighted average number of shares	**182,171,720**	**177,451,333**

Earnings per share	2012	2011
Basic	$1.47	$1.38
Diluted	$1.29	$1.20

Equity based compensation awards are only treated as dilutive when their conversion to common shares would decrease earnings per share or increase loss per share from continuing operations. Unvested restricted shares without performance criteria are therefore included in the number of potentially dilutive shares. Incremental shares from ordinary restricted share options where relevant performance criteria have not been met are not included in the calculation of dilutive shares. In addition, where options are antidilutive, they are not included in the number of potentially dilutive shares.

25. Related party disclosures

The consolidated financial statements include LHL and the entities listed below:

Name	Domicile
Subsidiaries	
LICL	Bermuda
SML	Bermuda
LIHL	United Kingdom
LUK	United Kingdom
LIMSL	United Kingdom
LISL	United Kingdom
LMSCL	Canada
LMEL	United Arab Emirates
Associates	
AHL	Bermuda
SHL	Bermuda
Other controlled entities	
LHFT	United States
EBT	Jersey

All subsidiaries are wholly owned, either directly or indirectly.

25. Related party disclosures continued

The Group has issued subordinated loan notes via a trust vehicle – LHFT, refer to note 21. The Group effectively has 100% of the voting rights in LHFT. These rights are subject to the property trustee's obligations to seek the approval of the holders of LHFT's preferred securities in case of default and other limited circumstances where the property trustee would enforce its rights. While the ability of the Group to influence the actions of LHFT is limited by the Trust Agreement, LHFT was set up by the Group with the sole purpose of issuing the subordinated loan notes, is in essence controlled by the Group, and is therefore consolidated.

The EBT was established to assist in the administration of the Group's employee equity based compensation schemes. While the Group does not have legal ownership of the EBT and the ability of the Group to influence the actions of the EBT is limited by the Trust Deed, the EBT was set up by the Group with the sole purpose of assisting in the administration of these schemes, is in essence controlled by the Group, and is therefore consolidated.

The Group has a Loan Facility Agreement (the 'Facility') with RBC Cees Trustee Limited, the Trustees of the EBT. The Facility is an interest free revolving credit facility under which the Trustee can request advances on demand, within the terms of the facility, up to a maximum aggregate of $40.0 million. The Facility may only be used by the Trustees for the purpose of achieving the objectives of the EBT. During the year ended 31 December 2012, the Group had made advances of $10.3 million (2011 – $4.0 million) to the EBT under the terms of the Facility.

During the year ended 31 December 2012 the Group donated 2,901,233 (2011 – 4,028,423) treasury shares to the EBT at the prevailing market rate. The total value of the treasury share donation was $35.8 million (2011 – $40.8 million).

LICL holds $298.1 million (2011 – $311.5 million) of cash and cash equivalents and fixed income securities in trust for the benefit of LUK relating to intra-group reinsurance agreements.

In 2012 the Group completed the process of liquidating its LMEL subsidiary and ceased all LMEL operations.

Key management compensation
Remuneration for key management, the Group's Executive and Non-Executive Directors, was as follows:

For the year ended 31 December	2012 $m	2011 $m
Short-term compensation	13.7	7.8
Equity based compensation	7.4	6.0
Directors' fees and expenses	1.7	2.4
Total	**22.8**	**16.2**

The Directors' fees and expenses includes $0.4 million (2011 – $0.9 million) paid to significant founding shareholders. Non-Executive Directors, with the exception of Neil McConachie, do not receive any benefits in addition to their agreed fees and expenses and do not participate in any of the Group's incentive, performance or pension plans. Neil McConachie left the company as an employee on 30 June 2012, relinquishing his executive responsibilities and became a Non-Executive Director effective 1 July 2012. He is able to exercise previously granted RSS awards when they have vested and subject to performance conditions being met, provided he remains a Non-Executive Director.

Transactions with a shareholder
During 2011 two of the Group's Executive Directors sold management team ordinary warrants to an external buyer who has substantial existing interest in Lancashire warrants. The details are as follows:

Date	Number	Price per share	$m
27 May 2011	350,000	$5.65	2.0
29 September 2011	2,000,000	$6.69	13.4
Total	**2,350,000**	**$6.53**	**15.4**

Transactions with Lancashire Foundation
Cash donations to the Lancashire Foundation have been approved by the Board of Directors as follows:

Date	$m
3 November 2011	1.3
7 November 2012	1.4

Transactions with associates
On 18 January 2012, following the 1 January 2012 property retrocession renewals and resulting capital requirements in ARL, AHL returned previously called capital requirements to the Group in the amount of $14.9 million. Subsequently, $6.0 million of capital calls were made during the year, for a net return of capital from AHL for the period of $8.9 million (31 December 2011 - investment in AHL of $50.0 million).

In relation to transactions with ARL, the following amounts were included in the consolidated statement of comprehensive income and the consolidated balance sheet:

As at 31 December	2012 $m	2011 $m
Consolidated statement of comprehensive income		
Outwards reinsurance premiums	64.8	12.2
Insurance loss and loss adjustment expenses recoverable	17.7	–
Insurance acquisition expenses ceded	9.0	1.5
Consolidated balance sheet		
Reinsurance recoveries	17.7	–
Unearned premiums on premiums ceded	3.5	5.5
Amounts payable to reinsurers	(18.4)	(2.7)
Deferred acquisition costs ceded	(0.6)	(0.7)

Contingent profit commission may be payable to the Group depending on the ultimate performance of ARL.

During 2012 SML entered into and underwriting services agreement with SRL and SHL to provide various services relating to underwriting, actuarial, premium payments and relevant deductions, acquisition expenses and receipt of claims.

During the year ended 31 December 2012 the Group did not enter any financial transactions with SHL apart from its initial investment discussed in note 16. In late 2012 SML entered into an underwriting services agreement with SRL and SHL to provide various underwriting and related services.

26. Non-cash transactions
TBAs classified as derivatives were settled net during the year with purchases and sales of $32.6 million (2011 – $4.8 million) and $32.6 million (2011 – $4.8 million) respectively.

27. Statutory requirements and dividend restrictions

The primary source of capital used by the Group is equity shareholders' funds and borrowings. As a holding company, LHL relies on dividends from its operating entities to provide the cash flow required for debt service and dividends to shareholders. The operating entities' ability to pay dividends and make capital distributions is subject to the legal and regulatory restrictions of the jurisdictions in which they operate. For the primary operating entities these are based principally on the amount of premiums written and reserves for losses and loss adjustment expenses, subject to overall minimum solvency requirements. Operating entity statutory capital and surplus is different from shareholders' equity due to certain items that are capitalised under IFRS but expensed or have a different valuation basis for regulatory reporting, or are not admitted under insurance regulations.

Annual statutory capital and surplus reported to regulatory authorities by the primary operating entities is as follows:

As at 31 December	2012 LICL $m	2012 LUK £m	2011 LICL $m	2011 LUK £m
Statutory capital and surplus	1,293.8	115.3	1,132.2	145.1
Minimum required statutory capital and surplus	255.5	23.8	250.5	25.4

For LUK, various capital calculations are performed and an ICA is presented to the FSA. The FSA then considers the capital calculations and issues an ICG, reflecting the FSA's own view as to the level of capital required. The FSA considers that a decrease in an insurance company's capital below the level of its ICG represents a regulatory intervention point.

LICL is required to maintain a minimum liquidity ratio, whereby relevant assets, as defined in the regulations, must exceed 75% of relevant liabilities. As at 31 December 2012 and 2011 the liquidity ratio was met. LICL is also required to perform various capital calculations under the BMA's regulatory framework. An assessment is made of LICL's capital needs and a target capital amount is determined. The BMA may require a further capital loading on the target capital amount in certain circumstances. The BMA considers that a decrease in capital below the target level represents a regulatory intervention point.

As at 31 December 2012 and 2011 the capital requirements of both regulatory jurisdictions were met.

28. Subsequent events

Dividend

On 20 February 2013 the Board of Directors declared the payment of an ordinary dividend of 10.0 cents per common share and a special dividend of $1.05 per share to shareholders of record on 22 March 2013, with a settlement date of 17 April 2013. The ordinary dividend payable will be approximately $19.1 million and the special dividend payable will be approximately $200.9 million. An amount equivalent to the dividend accrues on all RSS options and is paid at the time of exercise, pro-rata according to the number of RSS options that vest.

Return of capital from associate

On 5 February 2013 SHL returned previously called capital requirements to the Group in the amount of $22.9 million.