lancashire
HOLDINGS LIMITED

Notes & tables

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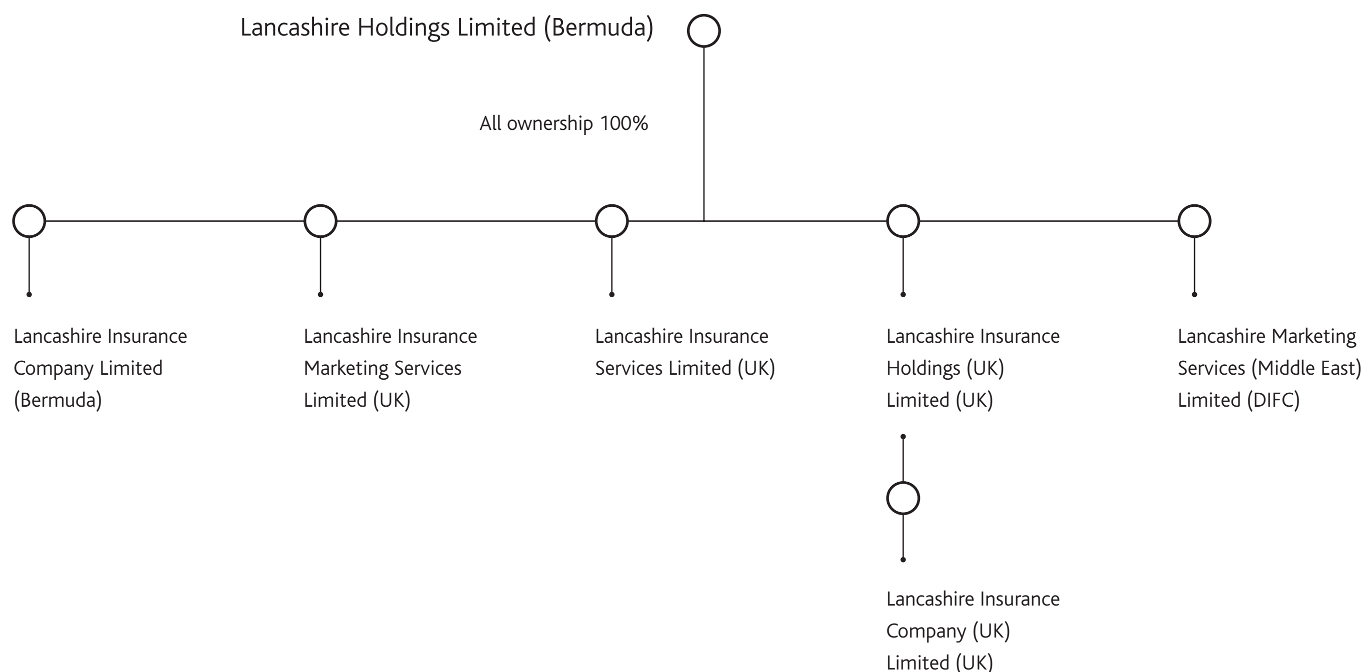
Group operating structure



Lancashire Holdings Limited and its subsidiaries (the "Group") are providers of global specialty insurance and reinsurance products. Lancashire Holdings Limited ("Lancashire" or the "Company") was incorporated under the laws of Bermuda on October 12, 2005. Lancashire's shares are admitted to trading on AIM, a subsidiary market of the London Stock Exchange. The registered office of Lancashire is Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda. Lancashire has five wholly owned subsidiaries: Lancashire Insurance Company Limited ("LICL"), Lancashire Insurance Holdings (UK) Limited ("LIHUKL"), Lancashire Insurance Marketing Services Limited ("LIMSL"), Lancashire Insurance Services Limited ("LISL") and Lancashire Marketing Services (Middle East) Limited ("LMSMEL"). LIHUKL is a holding company for a wholly owned operating subsidiary, Lancashire Insurance Company (UK) Limited ("LICUKL").

LICL and LICUKL are currently the Group's principal operating subsidiaries. LICL was incorporated under the laws of Bermuda on October 28, 2005 and is authorised by the Bermuda Monetary Authority (the "BMA") as a Class 4 general insurer. LICL provides insurance and reinsurance products to its customers, with an emphasis on property, energy, marine and aviation lines of business. LICUKL was incorporated under the laws of England & Wales on March 17, 2006 and is authorised by the United Kingdom Financial Services Authority (the "FSA") to conduct general insurance business. The products provided are the same as those provided by LICL. LICUKL is also registered as a Class 3 general insurer in Bermuda and has a permit issued under the Bermuda Companies Act 1981 to enable certain activities related to its insurance business to be performed from Bermuda.

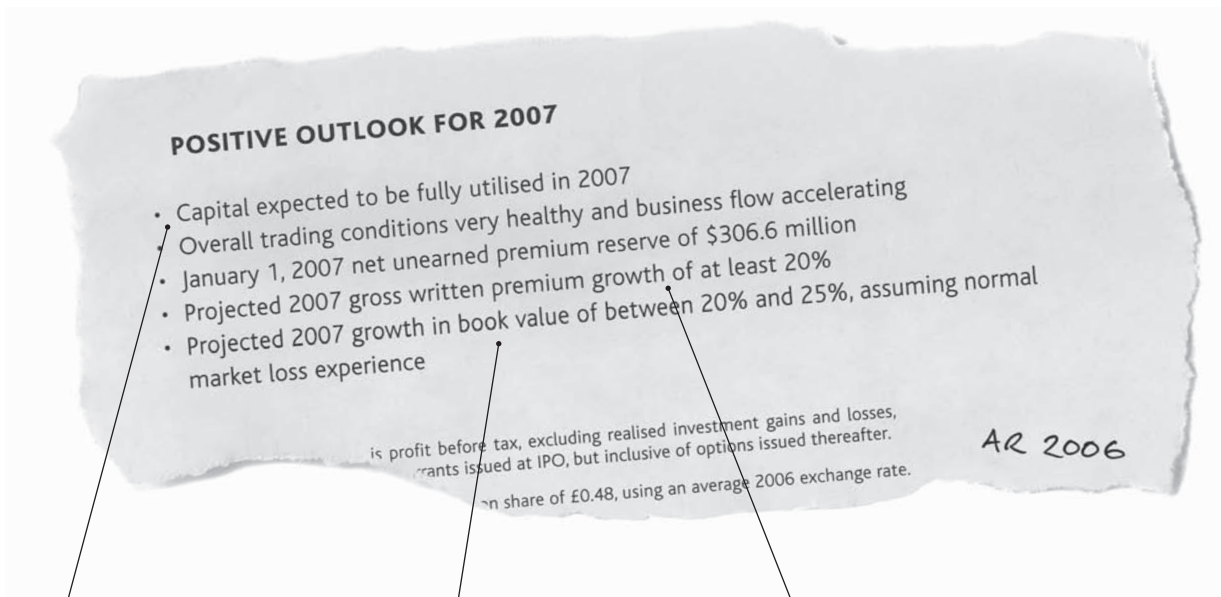
LIMSL is authorised by the FSA to undertake insurance mediation activities. LIMSL provides business introduction and other support services to LICL in the United Kingdom, and was incorporated under the laws of England & Wales on October 7, 2005.

LISL was incorporated under the laws of England & Wales on March 17, 2006. LISL provides support services to LIMSL and LICUKL.

LMSMEL was incorporated under the laws of the Dubai International Financial Centre ("DIFC") on March 11, 2007 and is authorised by the Dubai Financial Services Authority ("DFSA") to undertake insurance intermediation activities.

2006

~ Last year we set out a positive outlook for 2007, with some aggressive targets. Most were not only met, but exceeded.



POSITIVE OUTLOOK FOR 2007

- Capital expected to be fully utilised in 2007
- Overall trading conditions very healthy and business flow accelerating
- January 1, 2007 net unearned premium reserve of $306.6 million
- Projected 2007 gross written premium growth of at least 20%
- Projected 2007 growth in book value of between 20% and 25%, assuming normal market loss experience

is profit before tax, excluding realised investment gains and losses,
rants issued at IPO, but inclusive of options issued thereafter.
n share of £0.48, using an average 2006 exchange rate.

AR 2006

with a low loss ratio, in the final quarter of 2007, the Company decided to return $339.3 million of capital to shareholders by way of share repurchases, $100.2 million and the declaration of a strategic dividend, $239.1 million.

growth in fully coverted book value was 31.7%, including dividends.

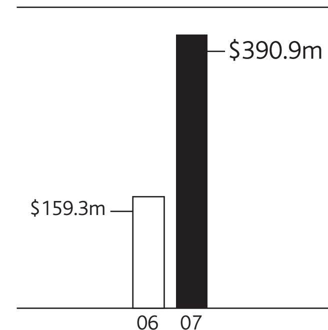
gross written premium in 2007 grew by 20.3%.

2007

financial highlights

• Growth in fully converted book value per share, plus dividends, 31.7 per cent
• Profit after tax of $390.9 million, a 145.4 per cent increase from 2006
• Gross written premiums of $753.1 million
• Loss ratio of 23.9 per cent
• Combined ratio of 46.3 per cent
• Strategic dividend of $239.1 million
• Share repurchases of $100.2 million

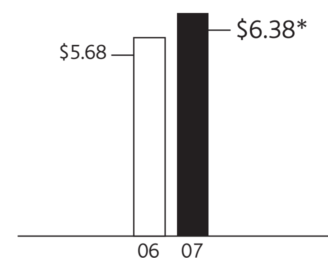
profit after tax ($)



operating highlights

• Successfully avoided losses from credit crisis
• Excellent first full year for UK underwriting platform
• Middle East marketing operation authorised and fully operational
• Experienced team expanded to 79 people across the Group

fully converted book value per share ($)



*excluding dividend of $1.10 (£0.5622) per share which was declared on December 10, 2007

outlook for 2008

• Maintain underwriting discipline as trading conditions become more challenging
• Continue to follow a prudent and active capital management philosophy

Still first

~ This is my first report as Chairman of Lancashire Holdings Limited and I am pleased to report a spectacular set of results for the Lancashire Group.

Although 2007 was only the Group's second full year of operations, we delivered 31.7 per cent growth in fully converted book value per share plus dividends and a profit after tax of $390.9 million or $1.91 per common share. The details behind these results are set out in the Chief Executive Officer's review and the review of results and outlook.

insurance business model

Lancashire is an insurance underwriting Group. We are not predominantly a reinsurance operation. Only 16 per cent of the Group's premium in 2007 was for reinsurance. Our area of expertise is in specialty direct short-tailed lines within the property, energy, marine and aviation segments. We do not anticipate the need to significantly diversify further into other classes of business although all options will be considered as we fulfil our aim to be nimble through changing market conditions.

capital management and investments

We intend to pursue an active capital management strategy through the market cycle. Our capital management plan is simple to articulate but the timing is difficult to predict, in the sense that any large insurance loss event is difficult to predict. We will match our capital to the underwriting opportunities that we see at any given time. A consequence of this strategy is that in a rapidly-changing market we do not intend to commit to specific capital actions far in advance.

In line with our strategy, at the end of 2007, following two benign loss years, we agreed to return a total of $339.3 million of capital to our shareholders. In late 2007 we completed share repurchases of $100.2 million and we declared a strategic dividend of $239.1 million which was paid to shareholders in January 2008.

We have a conservative approach to investing. In 2007 we achieved a 6.4 per cent return on our investment portfolio. This was achieved despite holding a highly defensive portfolio of fixed income assets and few equities. We have no significant exposure to the U.S. sub-prime crisis.

cycle management

Our over-riding goal is to generate a superior risk-adjusted return over time. When new opportunities arise and a growth strategy is appropriate, we expect our goal will normally be best achieved through organic growth rather than strategic acquisitions. Conversely when market conditions deteriorate for an extended period, our goal will be achieved through maintaining a relatively lean operational base, a sophisticated information technology platform and, of course, a strong focus on underwriting integrity.

group structure and people

Lancashire has operating companies in three key jurisdictions. It has underwriting companies in Bermuda and London, and a marketing operation in Dubai. We are more or less fully staffed and the Bermuda and London companies have obtained important insurance authorisations in key jurisdictions, particularly in our key markets in Europe and the USA.

Throughout 2007 the Board has kept the strategic direction of the Group, and the risk guidelines that inform our underwriting and capital requirements, under review.

The Board of Lancashire is keen to achieve the highest standards of corporate governance. When Lancashire was founded at the end of 2005, we made it clear that compliance with the UK Combined Code on Corporate Governance was a heart-felt aspiration, even though our listing on AIM does not fully require it. The details of our movement towards this goal are set out in the rest of this report.

I am especially grateful to Bob Spass for his guiding wisdom and experience in steering the Board until I replaced him on May 1, 2007, and for remaining as a non-executive Director thereafter. We were also delighted that Jens Juul joined us as an independent non-executive Director on November 16, 2007.

Finally, I would like to thank Richard Brindle, his executive team and all our staff for their dedication. These results are a tribute to their hard work, skill and teamwork.

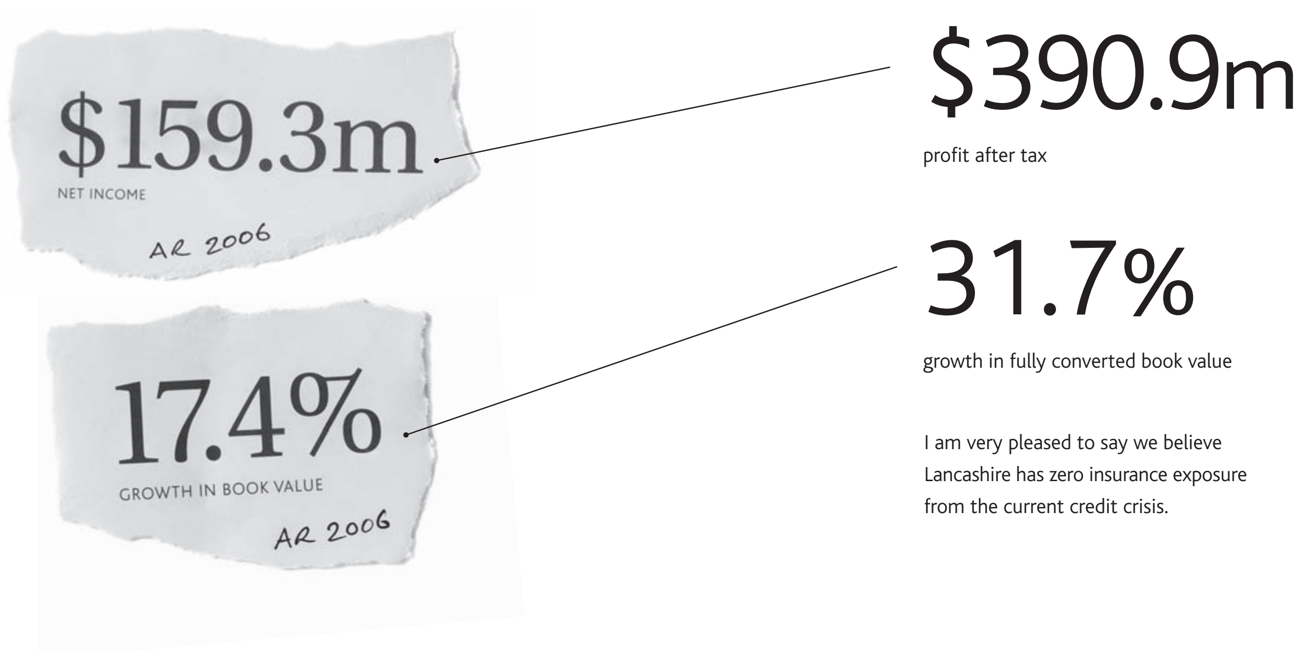
Martin Thomas, Non-Executive Chairman

Year two

~ In only our second year of operations, Lancashire has produced a remarkable set of results.

To have achieved a return of 31.7 per cent for our shareholders is testament to our people, our risk management and to our disciplined and diversified underwriting strategy. The success in 2007 was led by our exceptional underwriting result, evident in a combined ratio of 46.3 per cent. Our risk appetite on investments is low and that was the correct approach in hazardous markets. Against this background we are pleased to have achieved a total investment return of 6.4 per cent. Finally, we were delighted to return $339.3 million back to our shareholders via share repurchases and dividends, fulfiling our promise to manage capital in line with the underwriting cycle.

The market is softening across the board nonetheless there is plenty of attractive business in the majority of the lines we write. Lancashire writes direct specialty short-tail insurance, combined with a small amount of reinsurance. Our approach lends itself to profitable underwriting in softening markets where risk selection is paramount. As we progress through 2008, absent the market hardening, we expect that our premiums will decline from 2007, however we are well positioned to write a profitable book of business in 2008. We have no plans to compensate by venturing into areas we do not understand, a dangerous strategy indeed that is all too common. We also have little appetite to search for acquisitions and are comfortable our original business plan is working well. Acquisitions tend to be distracting for management and avoiding distractions is particularly important at this critical time in the cycle. We think a better use of our time, mine included, is to concentrate on the main business in hand – producing an excellent underwriting performance.



$390.9m

profit after tax

31.7%

growth in fully converted book value

I am very pleased to say we believe Lancashire has zero insurance exposure from the current credit crisis.

I am very pleased to say we believe Lancashire has zero insurance exposure from the credit crisis. This debacle appears to have very serious financial implications for the insurance industry. So far we have only seen the tip of the iceberg – I expect the true significance will increasingly manifest itself in the financial results of a broad section of companies as we go through 2008. Our investment approach will continue to be defensive. We have exited all non-agency structured products, and have no exposure to sub-prime securities or mono-line insurers. Lancashire has positioned both its insurance and investment portfolios appropriately for the current environment and we are confident we can produce a good return for our shareholders in what may be more challenging times ahead.

Richard Brindle

Richard Brindle, Chief Executive Officer

Loss ratio 23.9%

~ Returns achieved must be looked at in the context of the risk undertaken. Consequently, we aim to achieve the best risk-adjusted return, not just return in isolation.

1. business overview
Lancashire is a provider of insurance and reinsurance products on a global basis. It specialises predominantly in property specialty insurance and has subsidiaries in Bermuda, London and Dubai. Lancashire writes risks within property, energy, marine and aviation segments of the market and has a group rating from A.M. Best of A minus (excellent).

2. business strategy
Our aim is to optimise the balance between capital and risk to maximise our risk-adjusted return in the long-term. We aim to do this by sticking true to the following strategic cornerstones:

– underwriting comes first.

As an insurance company, we place the operational aim of excellence in underwriting. Each risk underwritten must bear scrutiny on an individual basis and as part of the overall portfolio. If we can achieve this year in, year out, consistently, we believe this will achieve a superior risk-adjusted return for shareholders.

– maintain a strong balance sheet.

We have a range of risk tolerances, and our balance sheet must be sufficient at all times to meet those requirements. We aim to meet policyholders' claims promptly, accurately and completely. Our balance sheets should instill a high level of confidence in all stakeholders, including shareholders, regulators, rating agencies, counter-parties and employees.

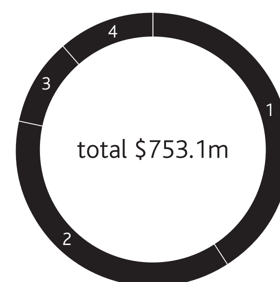
– stay nimble.

To grow in a hard market and shrink in a soft market with efficiency means staying nimble. We achieve this through a collegiate underwriting approach – maintaining tight control on overheads and keeping our eyes open for good opportunities.

– manage capital through the cycle.

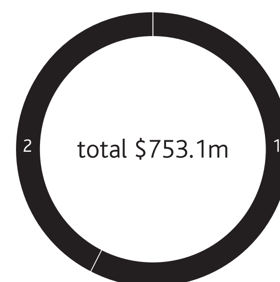
We don't have a strategic level of capital. Underwriting opportunities and the risk they carry will drive capital, not the other way around. We plan to carry sufficient capital to support the risk we assume, and won't let our capital levels dictate how much premium we generate.

2007 gross GAAP premium

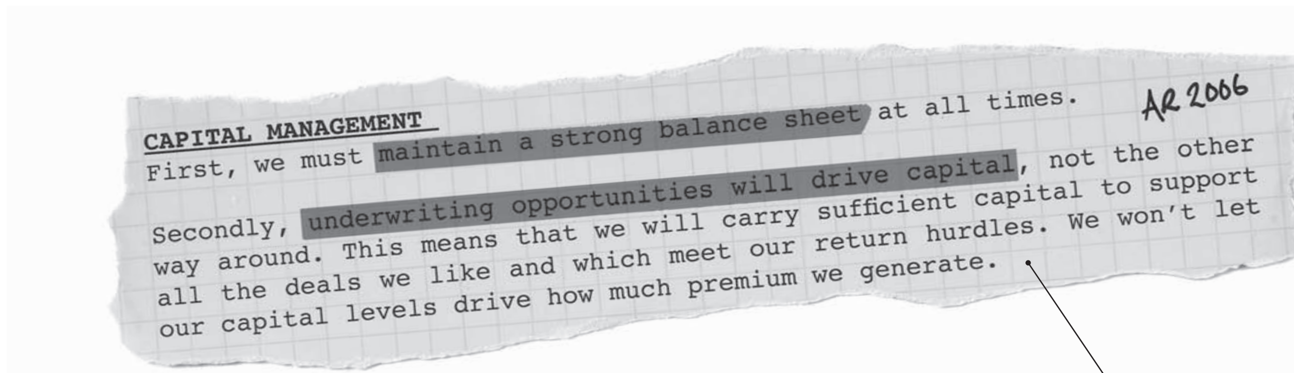


1. property – $309.3m
2. energy – $282.7m
3. marine – $76.9m
4. aviation – $84.2m

2007 premium % by office



1. Bermuda – $433.5m
2. London – $319.6m



We have a certain amount of excess capital. This recognises that the current softening of the cycle will almost certainly result in lower profits in 2008 than 2007.

the relationship between risk and return:
We believe that risk and return go hand in hand. Returns achieved must be looked at in the context of the risk undertaken. Consequently, we aim to achieve the best risk-adjusted return, not just return in isolation. We measure return as the growth in fully diluted book value per share, adjusted for dividends.

We have stated that we seek to achieve a return of LIBOR plus 13 per cent across the cycle. Our expected returns in any one year will vary through the cycle, as the embedded profitability within the classes we write changes over time. But our risk tolerances should change little. Depending on the type of event or accumulation of events over a period of time, we are willing to risk only a certain amount of our capital at any point in time regardless of underlying trading conditions.

our philosophy:
We underwrite a diversified short-tail property specialty book of insurance risks. We aim to maintain a balance between classes exposed to natural catastrophes and classes that are not. We will allocate capital between these two areas as the relative attractiveness of each ebbs and flows. Within the two areas we shift focus between segments, individual classes within segments, and down to the individual contract level in each class. By doing so, we plan to maintain an efficient portfolio at all times.

Our risk tolerance on investments is low at the best of times, and particularly low in these turbulent times. We aren't an investment company, we are an insurance company, and it's appropriate we should allocate nearly all our risk tolerance to insurance. Our primary investment objectives are to preserve capital and provide adequate liquidity to support the company's payment of claims. A secondary objective is to maximise total risk-adjusted return, with low volatility.

3. business environment and outlook
Following excellent industry results in 2006 and 2007, the picture for 2008 is one of deteriorating underwriting conditions coupled with unpredictable investment markets. Trading conditions are acceptable but it is very unlikely that the industry returns of 2007 will be repeated.

At this time, there is a shortage of credit available in the global markets. Banks are less willing to lend money because they are unsure of their exposure to loss from loan defaults, among other things. This crisis has, and will continue to, manifest itself in the downgrading of financial securities, in particular securitised debt. The credit crisis is also being felt by certain parts of the insurance market, including providers of bond insurance and Directors and Officers insurance. Crucially, Lancashire does not believe it has exposure to the credit crisis in its insurance portfolio, or indeed any material exposure in its investment portfolio.

The present insurance cycle is now into its third year. We have seen two years with low levels of industry loss, less than anticipated, and while this has resulted in strong profits for the industry the corollary is a historically-high supply of capacity. This capacity is a large factor in the steady reduction in pricing across the market.

Despite the softening market, trading conditions for 2008 remain good for Lancashire. Such was the impact of Hurricanes Katrina, Rita and Wilma on pricing at the beginning of the current cycle that rates had significant room to fall in many classes before reaching unacceptable levels. This does not hold true for all classes, but it does apply to much of the property and energy segments, which together comprise almost 80 per cent of Lancashire's total portfolio.

In 2007 the investment markets across most asset classes were volatile, particularly in the second half of the year. This was brought about by many reasons: portfolio write-downs, ratings downgrades and malfunctioning money markets. A flight to quality led to sharp falls in treasury yields. Earnings releases began to quantify the impact of sub-prime mortgage problems on the balance sheets of banks and other financial institutions. Equity markets eked out modest gains in 2007 characterised by a good first half of the year and a tougher second half. Lancashire not only navigated these treacherous waters without major incident but produced a strong risk-adjusted return in the process.

All major asset classes look challenging for 2008 and we see no reason to change our defensive strategy.

4. review of performance and outlook for 2008

Lancashire produced an exceptional result in 2007, generating net income of $390.9 million and agreeing to return $339.3 million of capital to shareholders.

Financial highlights for the twelve months to December 31, 2007 were as follows:

- Return on equity of 31.7 per cent (2006 – 17.4 per cent), measured as the growth in fully converted book value per share plus dividends;
- Fully converted book value per share at December 31, 2007 was $6.38 (2006 – $5.68);
- Gross written premiums of $753.1 million (2006 – $626.0 million), an increase of 20.3 per cent from 2006. Net written premiums increased 21.8 per cent;
- Loss ratio of 23.9 per cent (2006 – 16.1 per cent) and a combined ratio of 46.3 per cent (2006 – 44.3 per cent);
- Total investment return of 6.4 per cent (2006 – 6.6 per cent), including net investment income, realised gains and losses, and unrealised gains and losses;
- Net income after tax of $390.9 million (2006 – $159.3 million), or $1.91 diluted earnings per share (2006 – $0.79 per share).

Return on equity was a stellar 31.7 per cent for the year and followed a very strong 17.4 per cent return the previous year. This again was better than expected, and placed Lancashire at the top of its group of peers. We target a return on equity of LIBOR plus 13 per cent across the cycle. The cycle would be expected to end when trading conditions next improve dramatically again. To date, we have achieved a compound annual return of 22.3 per cent which equates to LIBOR plus 17 per cent. This means that, so far, we are well ahead of our cross-cycle target. However, the softening of market rates is expected to reduce profitability in 2008 and beyond, until the next market changing event. We believe our cross-cycle return target remains both appropriate and attractive to shareholders. It is a challenging target but one we are confident we can meet within appropriate risk guidelines.

Further comments on our 2007 financial results and outlook for 2008 are given below.

a) underwriting

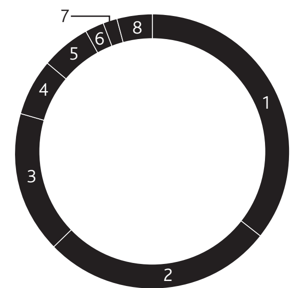
Gross written premiums increased 20.3 per cent compared to 2006. We began underwriting operations in December 2005, and 2006 was our first full year of operations during which we gradually built up our team, our relationships and our infrastructure. The growth in annual premium written in 2007 compared to 2006 was due to reaching a fully staffed and operational position. 2007 also saw a significant benefit from our UK operating platform, which began underwriting in late 2006.

During 2007, a greater amount of the Group's premium was ceded than in 2006, partly reflecting the growth in written premium. Net written premiums increased in 2007 compared to 2006. The business that Lancashire conducted with Sirocco Reinsurance Limited ("Sirocco Re"), the Bermuda incorporated energy business sidecar sponsored by Lancashire in 2006, was commuted effective December 31, 2007. A one-off profit commission received from Sirocco Re of $7.8 million was netted off against Lancashire's business acquisition costs in 2007.

Net earned premiums as a proportion of net written premiums were 91.7 per cent for the year, up from 44.5 per cent in 2006. The lag in the earning out of written premium in 2006 reflects the fact that our business was ramping up gradually through 2006 from a standing start. Much of the earning on insurance and reinsurance contracts written in the latter half of 2006 was recognised in the 2007 financial results.

The loss ratio of 23.9 per cent for the twelve months ended December 31, 2007 represents an exceptional underwriting performance in all segments. We set our underwriting standards high. Nonetheless, the loss ratios achieved in 2007 and 2006 were significantly lower than anticipated.

gross premiums written by geographic area



1. worldwide offshore – $268.1m
2. worldwide, including the U.S. and Canada – $205.0m
3. U.S. and Canada – $127.2m
4. worldwide, excluding the U.S. and Canada – $49.8m
5. europe – $43.2m
6. far east – $17.3m
7. middle east – $13.5m
8. rest of world – $29.0m

natural catastrophe classes:
2007 was a relatively benign year for natural disasters, certainly for large natural disasters. There was a higher than normal frequency of small to medium size events outside the U.S., most notably the European storm Kyrill in January 2007 and the summer flooding in the UK, but we also saw a number of typhoons in the Far East, an earthquake in Peru and flooding in Australia. In the Americas there were no insured losses of note from natural catastrophes although we were reminded of the potential of loss in the shape of two extremely powerful Category Five hurricanes that formed in the Gulf of Mexico in short succession. These resulted in little insured damage. Indeed, Lancashire performed very well across this segment during 2007; and significantly better than the general market as a whole.

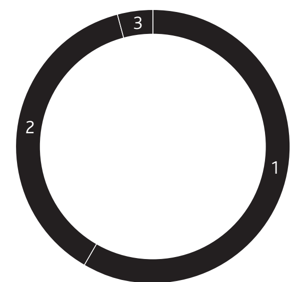
non-elemental classes:
In 2007 there were several material non-elemental (non-natural catastrophe) losses but, similar to the natural catastrophe classes, there were no large insured losses to cause widespread market loss. In certain pockets we saw a reasonably high level of medium size losses including the marine and general aviation markets. Lancashire does not write general aviation – we don't think the pricing is nearly good enough – and we produced an excellent underwriting result in our marine book. The non-elemental parts of Lancashire's property and energy segments did not experience any major loss during 2007. Our non-elemental book performed well, with the exception of onshore energy which generated a small underwriting loss. This was the only class we write that produced an overall underwriting loss during 2007.

b) investments
Net investment income was $78.4 million for the twelve months ended December 31, 2007 (2006 – $54.2 million), an increase of 44.6 per cent over the same period in 2006. The increase in investment income is primarily due to high net operating cash flow, resulting in higher net invested assets. We expect cash flows to remain positive through 2008, although this will be offset to some extent by the dividend payment of $239.1 million in January 2008, and lower investment yields now than a year ago.

Our investment portfolio returned 6.4 per cent in 2007. Given the underlying investment conditions and our highly conservative strategy, we were pleased with this performance. Our fixed income portfolio returned 6.1 per cent and our modest equity allocation returned a very impressive 8.9 per cent.

At December 31, 2007 the fixed income portfolio plus managed cash had a duration of 1.4 years and a credit quality of AA+. The portfolio was comprised of 58.6 per cent fixed income, 4.1 per cent equities and 37.3 per cent cash.

total investment portfolio



1. fixed income – 58.6%
2. cash – 37.3%
3. equities – 4.1%

c) outlook for 2008

In 2007 despite two category five Atlantic hurricanes, insured losses in the United States and elsewhere have been lower than average. Those catastrophe losses that have occurred such as the Kyrill European storm, the UK floods and the Australian flooding have not been of a magnitude to affect either market capacity or pricing. The increasing incidence and severity of risk losses in Onshore Energy and Property during the last quarter of 2007 which have continued through the first quarter of 2008 may have a moderating effect on the pace of market softening but will not be enough to stop it. The Marine and Aviation lines both suffered losses that exceeded market premium during 2007 and as a result they have seen a steadying of rates; the segments that Lancashire writes within these classes were largely unaffected by the losses.

For 2008 the market is softening across the Board and we expect gross written premiums to be lower than 2007. Nonetheless, there is plenty of attractive business in the majority of the lines that we write. We are well-positioned to negotiate our way through the insurance and reinsurance cycle, and to position our resources in the most attractive segments.

In 2008 we would expect our loss ratio to be materially higher than 2007, even with another relatively benign year. However we do expect it to stand up well compared to the industry as a whole.

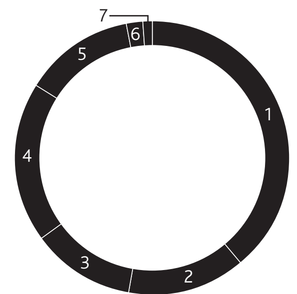
The outlook for investments in 2008 is cloudy. The central banks have already cut rates in early 2008, and deteriorating growth fundamentals may prompt further rate reductions. At the same time inflation is becoming an increasing concern. Equity markets are recognizing the impact of a looming U.S. recession and deteriorating worldwide economic conditions. Cash yields are falling as a result of the interest rate cuts. Our principle investment aim for 2008 will be 'don't lose money'. If we can make some too, even better, however by limiting the downside risk we are inevitably also limiting the upside. We believe that is the correct approach for now.

5. enterprise risk management

Lancashire has a comprehensive Enterprise Risk Management ("ERM") program. ERM is co-ordinated by Lancashire's Chief Risk Officer ("CRO") who reports to the Board of Directors. Risk Committees have been formed at the operating entity level. At Group level, the role of the Risk Committee is carried out by the Company's Board of Directors. The Board of Directors sets the overall risk profile and risk appetite for Lancashire. The CRO is responsible for translating this into business tolerance levels on specific identified risks and monitoring the adherence to these.

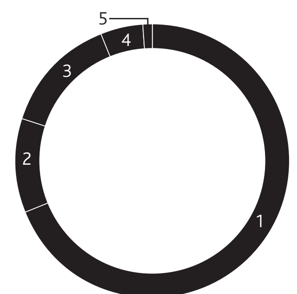
The Risk Committees, with input from executive and senior management, define tolerance levels over all categories of risk for the operating entities. This includes the level of capital the Group and individual operating entities are willing to expose to certain risks.

fixed income allocation



1. cash and short-term – 39%
2. treasuries – 14%
3. agency debt – 12%
4. corp bonds – 19%
5. agency mbs – 13%
6. convertible debt – 2%
7. other – 1%

credit quality of fixed income portfolio



1. AAA (inc A-1+, A-1) – 69%
2. AA+, AA, AA- – 11%
3. A+, A, A- – 14%
4. BBB+, BBB, BBB- – 5%
5. other – 1%

economic capital model

Lancashire has developed a sophisticated economic capital model called BLAST. BLAST provides management and the Board of Directors with information on risk and return that can assist with business decisions. BLAST is an integral part of Lancashire's ERM program. It is primarily a stochastic model. It encompasses insurance risk, market risk, credit risk and other general risks including operational risk. It requires the input of a large number of parameters and data. The inputs include historical data and projected future premium income, reinsurance programs, loss ratios, default rates, asset allocations and operational costs. All classes of business, including non-elemental classes, are within the capabilities of the model.

BLAST helps management and the Board of Directors determine the level of capital required at both Lancashire and the operating entity level to meet the combined risk from a wide range of categories. Assisted by BLAST, Lancashire seeks to achieve an improved risk-adjusted return over time.

The management of various types of risks is described in more detail below.

a. insurance risk

Lancashire underwrites contracts that transfer insurance risk. Lancashire underwrites worldwide short-tail insurance and reinsurance property risks, including risks exposed to natural catastrophes. Lancashire's exposure in connection with insurance contracts is, in the event of insured losses, whether premium 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, among other factors. Lancashire's underwriters assess likely losses using their experience and knowledge of past loss experience as well as current circumstances. This allows them to estimate the premium sufficient to meet likely losses and expenses. Lancashire considers insurance risk at an individual contract level, sector level, geographic level and at an aggregate portfolio level to ensure careful risk selection, limits on concentration and appropriate portfolio diversification are accomplished. Natural catastrophe exposed risks are modeled prior to execution.

reinsurance

Lancashire, 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 by entering into reinsurance arrangements. Reinsurance does not relieve Lancashire of its obligations to policyholders. Under Lancashire's reinsurance security policy, reinsurers are assessed and approved as appropriate security based on their financial strength ratings and other factors. The Group's Reinsurance Security Committee has defined limits per market by rating and an aggregate exposure to a rating band. Lancashire considers reinsurers that are not rated or do not fall within the pre-defined rating categories on a case by case basis, and would usually require collateral to be posted to support obligations. Lancashire monitors the credit-worthiness of its reinsurers on an ongoing basis. The Reinsurance Security Committee meets formally at least quarterly.

Reinsurance covers purchased typically include a combination of excess of loss reinsurance, proportional reinsurance and occasionally includes industry loss warranty covers. The mix of reinsurance cover is dependent on the specific loss mitigation requirements, market conditions and available capacity. The primary focus of Lancashire's reinsurance program to date has been to reduce Lancashire's net exposure to a large natural catastrophe loss in the U.S.. Lancashire also increasingly purchases cover to reduce net exposures to large losses from classes not exposed to natural catastrophes.

b. market risk

Investment guidelines are established by the Investment Committee of the Board of Directors. Investment guidelines set parameters within which Lancashire's external investment managers must operate. Important parameters include guidelines on permissible assets, duration ranges, credit quality and maturity. Investment guidelines exist at the individual portfolio level and for Lancashire's consolidated portfolio. Compliance with guidelines is monitored on a monthly basis. Any adjustments to the investment guidelines are approved by the Investment Committee and the Board of Directors.

Within the Group guidelines is a sub-set of guidelines for the portion of funds required to meet potential insurance liabilities in an extreme event, plus other near term liquidity requirements, the "core" portfolio. The core portfolio is invested in fixed income securities and cash and cash equivalents. The sub-set of guidelines adds a further degree of requirements, including fewer allowable asset classes, higher credit quality, shorter duration and higher liquidity. The primary objective of this portion of assets is liquidity and capital preservation.

Assets in excess of those required to settle potential insurance liabilities in an extreme event, plus other near term liquidity requirements, the "surplus" portfolio, are invested in fixed income securities, cash and cash equivalents and a modest amount of equity securities. These assets are not matched to specific insurance liabilities. In general, the duration is slightly longer, while maintaining focus on high quality assets. Lancashire also holds a modest amount of convertible debt securities. Currently, Lancashire does not hold any alternative investments such as hedge funds.

Lancashire 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.

Lancashire is also subject to market risk on its insurance portfolio. The most important measure to mitigate insurance market risk is to maintain strict underwriting standards. Examples of how Lancashire reacts to insurance market risk include the following:

- Review and produce underwriting plans and budgets as necessary;
- Reduce exposure to market sectors where conditions have softened;
- Purchase appropriate reinsurance cover to mitigate increased exposures;
- Closely monitor movements in rates, and terms and conditions;
- Regular review of output from Lancashire's economic capital model, BLAST, to judge up-to-date profitability of classes and sectors.

c. liquidity risk

Lancashire is exposed if proceeds from financial assets are not sufficient to fund obligations arising from its insurance contracts. Lancashire can be exposed to daily calls on its available investment assets, principally from insurance claims. Liquidity risk is the risk that cash may not be available to pay obligations when they are due without incurring an unreasonable cost.

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

In addition, the Board of Directors has established asset allocation and maturity parameters within the investment guidelines such that the majority of Lancashire's investments are in high quality assets which could be converted into cash promptly and at minimal expense. Management monitors market changes and outlooks and re-allocates 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. Lancashire is exposed to credit risk on its fixed income investment portfolio and derivative instruments, its inwards premium receivable from insureds and cedants, and on any amounts recoverable from reinsurers.

Credit risk on the fixed income portfolio is mitigated through Lancashire'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 BBB-/Baa3 may comprise no more than 5 per cent of shareholders' equity, with the exception of U.S. government and agency securities. In addition, no one issuer should exceed 5 per cent of shareholders' equity, with the exception of U.S. government and agency securities. Lancashire 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.

Lancashire is exposed to credit risk in the event of non-performance of counter-parties to derivative contracts. These counter-parties are high credit quality banks and therefore exposure is expected to be negligible. Further, these instruments are typically net settled and are short-term in nature.

Credit risk on inwards premium receivable from insureds and cedants is managed by conducting business with reputable broking organisations with established relationships and by rigorous cash collection procedures. Credit risk from reinsurance recoverables is primarily managed by review and approval of reinsurer security by Lancashire's Reinsurance Security Committee.

e. operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people or systems including the risk of fraud, safety, damage to physical assets, business disruption, system failure and transaction processing failure.

Lancashire has a robust internal corporate governance framework. Policies and procedures are documented and are reviewed at least quarterly. Lancashire's internal audit function assesses the key risk areas on an annual basis and performs reviews of these areas to evaluate whether controls are in place and are operating effectively.

Information technology risk tolerances have been identified and system performance is monitored continuously. Lancashire's disaster recovery plan is assessed and updated on a regular basis.

f. strategic risk

Strategic risk encompasses the risk that poor business planning and vision may produce a lower return on capital and value creation. Further, this could lead to risk tolerances being unclear or inappropriate. Management address this risk by a continual rigorous assessment of business goals. Lancashire's BLAST model is increasingly an integral part of the review of profitability and capital utilisation. Lancashire's strategy is reviewed with the Board of Directors on a quarterly basis. Market or economic events may lead to a need to re-assess strategy more frequently.

Further discussion of the risks affecting the company and the policies in place to mitigate those risks can be found in the risk disclosures section of the financial statements.

6. reputation

Lancashire has built an enviable market reputation in a short period of time. Our experienced team of underwriters are known for their in depth knowledge of the markets where we participate. The Lancashire name is synonymous with excellent service, prompt claims payment, fair judgement and strong client relationships.

7. stakeholder relationships

At Lancashire, we believe that success is unlikely to be achieved without a significant amount of effort put into relationships. These relationships encompass brokers, employees, regulators, rating agencies, analysts and others. All such relationships are highly valued.

a) brokers
It is difficult to overstate the importance of broker and customer relationships. Our business is almost all transacted through brokers. Brokers need to know that insurers of their clients have excellent financial strength, a thorough understanding of the risks at hand, and a willingness and ability to provide first class service. Lancashire strives to meet all of these requirements handily. More than ever we are placing greater emphasis on marketing, which we believe will continue to afford us access to virtually all major risks placed in the market in the classes underwritten by Lancashire.

b) employees
At March 7, 2008 we had 79 employees, 42 in Bermuda, 35 in London and 2 in Dubai. We are essentially fully staffed and do not expect our employee count to change much during 2008. This is a relatively small number of staff for a direct writer that should allow Lancashire to remain nimble through the cycle and react quickly to changing market conditions.

We strive to have the best employees in the industry. We expect our employees to work hard but we reward them accordingly. We also believe that as many as possible should become shareholders in Lancashire. This creates tremendous team spirit, and has been a huge part of our success to date. 8.9 per cent of our fully diluted share count is represented by management through shares, warrants or options. 94 per cent of our staff are owners of Lancashire's shares through actual share holdings or owners of warrants, options or restricted stock.

We completed a group wide anonymous staff satisfaction survey in 2007 and the results were very pleasing. The survey was distributed electronically to all employees in each jurisdiction where Lancashire has an office – Bermuda, London and Dubai.

The staff survey had a response rate of 86 per cent. The results in the aggregate were very favourable, particularly when compared to the normative database. The survey indicates that employees believe in Lancashire's strategy and understand how what they do contributes to the success of the company, and are generally very satisfied with Lancashire's approach to management and supervision. There is a strong sense of teamwork and cooperation, and a sense that the organisation respects diversity. Employees feel that Lancashire maintains a high ethical standard and are very proud of the work that they do. Employees also believed that management would respond to the results of the survey in a positive way.

c) regulators
We place high importance on our relationship with regulators and we monitor changes in regulatory requirements closely. Both our Bermuda insurance operations (regulated by the Bermuda Monetary Authority (BMA)) and our UK insurance operations (regulated by the Financial Services Authority (FSA)) were subject to routine regulatory reviews in 2007. We believe the results from each inspection to be satisfactory. Our marketing company in Dubai is regulated by the Dubai Financial Services Authority (DFSA).

Lancashire has also obtained eligibility as an excess and surplus lines insurer in many U.S. states. As at March 2008 our principal Bermuda operating subsidiary is eligible in 37 states including New York, Texas, Florida and Louisiana. Our UK subsidiary, which began underwriting in 2006 (some ten months after Bermuda), has excess and surplus lines eligibility in 34 U.S. states, including New York and Texas. During 2008 we plan to submit applications to obtain excess and surplus lines eligibility in the majority of the remaining U.S. states including New Jersey, California and Pennsylvania. For those U.S. states where we are not currently eligible Lancashire, subject to compliance with applicable law and regulation, may write insurance on a direct procurement basis or take advantage of appropriate exemptions.

d) rating agencies

Lancashire enjoys a positive relationship with rating agencies. We obtained a financial strength rating of A minus (Excellent) with a stable outlook from A.M. Best on December 16, 2005. This afforded us the ability to trade successfully in all the major global insurance markets. We continue to maintain the same rating and will continue to aim for an upgrade in the short to medium-term. We are also in conversations with Standard and Poor's (S&P) and Moody's with a view to obtaining satisfactory ratings from them in due course. In the meantime, our ability to write business has not been materially impaired by the absence to date of a published S&P or Moody's rating.

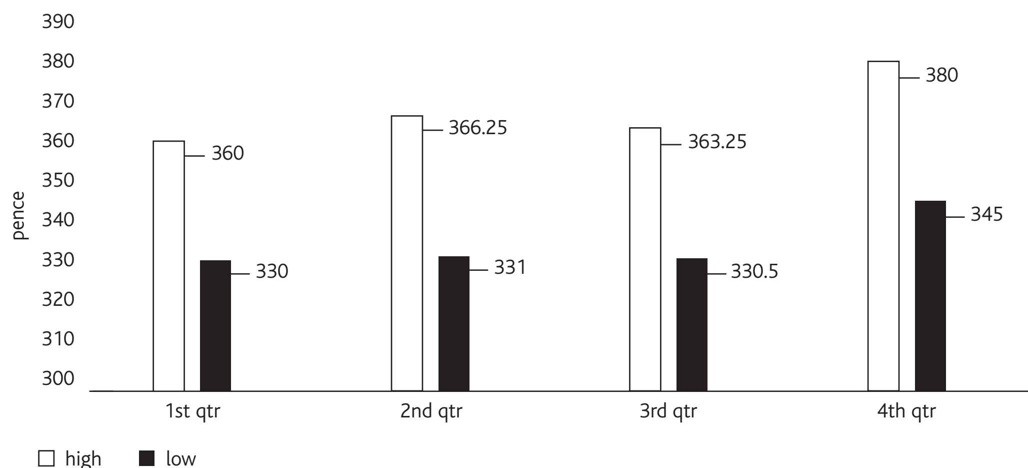
e) investor relations

We have spent significant time on investor relations. During 2007 we conducted many investor meetings and hosted successful investor days in New York, Boston and London, presenting to analysts, investors and potential investors. We plan to repeat these in 2008.

Lancashire became a public company from the start of its existence and Lancashire's shares are admitted to trading on AIM in London under the ticker symbol LRE.L. Unusually, we made the decision to announce financial results to the market on a quarterly basis from day one rather than the more typical UK market practice of publishing only half yearly results announcements. Following our results announcements we also conduct a conference call that is open to all investors, during which we discuss our results and answer questions. This provides the investment community a more up to date picture of Lancashire's financial results. The additional transparency has been welcomed.

Our share price increased 8.7 per cent during 2007 to close the year at 364 pence. A table of our high and low share prices by quarter is given below. Our market capitalisation at March 7, 2008 was £540.5 million.

2007 share price by quarter



capital and financial management

At December 31, 2005, following our private placement and initial public offering our shareholders' equity was $947 million. We also raised $125 million of subordinated debt. The debt is 30 year with a non-call 5 year prepayment option.

A strong operating performance meant we generated capital of $608 million over the 24 months to December 31, 2007, $191 million during 2006, and a further $417 million during 2007. In December 2007, we made the strategic decision to return $339.3 million of excess capital to shareholders, leaving total capital of $1,348 million at December 31, 2007, comprising $1,216 million of shareholders' equity and $132 million of subordinated debt. The return of capital totaling $339.3 million comprised a share repurchase totaling $100.2 million and a strategic dividend of $239.1 million.

In 2006, Lancashire were sponsors of a side-car called Sirocco Reinsurance Limited ("Sirocco Re"). Sirocco Re provided reinsurance protection to Lancashire for named windstorm damage to Gulf of Mexico energy risks. The protection was in the form of a quota share, with Lancashire receiving a ceding commission and a profit commission. Lancashire originally invested $20 million in Sirocco Holdings Limited ("Sirocco"). Following two successful years, the quota share agreement with Sirocco Re was commuted. Sirocco is expected to be wound-up in 2008.

There are several inter-linked factors which lead to decisions on what level of capital to maintain:

– The underwriting opportunities: we match capital to the underwriting opportunities ahead, and our assessment is that the underwriting opportunities are declining at this time.
– The level of various risk factors which we currently have, and what we anticipate having in the short to medium-term.
– The ability to raise capital from the financial markets.
– The stage of the cycle, meaning in this case the expected profitability for the next year which can absorb large losses.

We use our BLAST model to help determine the appropriate level of capital to carry.

BLAST produces data in the form of a stochastic distribution. The distribution includes the mean outcome and the result at various return periods, including very remote events. This is analysed at both the micro and the macro level. At the micro level, BLAST produces risk/return information for individual categories of risk and also within categories of risk, particularly insurance risk. For example, the calculation of present and projected financial outcomes for each insurance class, including non-elemental classes. At the macro level, BLAST 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. Diversification credit is calculated within categories, most notably within the insurance category, and across a range of risk categories.

Notwithstanding our substantial return of capital at the end of 2007, at February 2008 we have a certain amount of excess capital. This recognises that the current softening of the cycle will almost certainly result in lower profits in 2008 than 2007. It also acknowledges that raising money in the capital markets, particularly debt markets, is likely to be comparatively difficult and/or expensive in the short-term.

The composition of capital is driven by our appetite for leverage. Our leverage at December 31, 2007 was 9.8 per cent, a lower level than many of our peers. In the appropriate circumstances, we would be willing to increase our leverage somewhat. An increase in leverage would more likely take place as we enter a hardening market but this may not necessarily be the case. Maintaining a strong balance sheet will be the overriding factor in all capital management decisions.

There are no off-balance sheet forms of capital. We have a standard letter of credit facility which is used to secure certain amounts due to U.S. based insurers and to support certain other insurance obligations. The facility is $200 million, and $99 million is utilised at February 2008. The facility expires on July 16, 2012.

cash flows and liquidity

Cash flow to date has been overwhelmingly positive. In 2006 net cash flow from operating activities was $277 million. In 2007 it was $522 million. This is partly a function of the low number of loss events. Through December 31, 2007, our total claims payments since we started in business were $9.9 million. In 2008, we would expect our cash outflows to increase as a function of our expectation that loss events will rise. Nonetheless we expect our cash flow overall to remain positive.

Our cash needs are primarily to meet insurance liabilities and other short-term liabilities.

Lancashire manages its liquidity risks via its investment strategy to hold high quality, highly liquid securities, sufficient to meet its insurance liabilities. The creation of the core portfolio with its sub-set of guidelines helps ensure funds are readily available to meet potential insurance liabilities in an extreme event.

Neil McConachie, Chief Financial Officer

The team

Non-Executive Directors

Martin Thomas (age 44)
Non-Executive Chairman
Martin Thomas has been a solicitor and was most recently an official of the Bank of England on secondment to the EU Commission. At the Commission, he worked in the Financial Services Policy and Financial Markets Directorate of the EU Commission's Internal Market and Services Directorate General. Before Mr Thomas joined the Commission, he established the Financial Markets Law Committee at the Bank of England. Prior to that, he was Deputy Chief Executive of the Financial Law Panel and Senior Counsel to the European Central Bank in Frankfurt. He started his career in private practice, specialising in corporate and commercial litigation at Travers Smith, and the law and regulation of financial services at Clifford Chance.

Jens Juul (age 59)
Non-Executive Director
Jens Juul, the Honorary Consul of Sweden for Bermuda, has 29 years of international reinsurance experience. He founded and managed subsidiaries for the Storebrand Group in Latin America and Canada and was also the CFO of their U.S. subsidiary, Christiana General, prior to moving to Bermuda, where he was the founding CEO of Scandinavian Re until his retirement in 2002. He is an ARIAS-US certified arbitrator and umpire.

Ralf Oelssner (age 63)
Non-Executive Director
Ralf Oelssner was Vice President, Corporate Insurance for Lufthansa German Airlines until October 31, 2007. In 1979, he became Director, Corporate Insurance, and in 1990 was appointed Managing Director of Lufthansa's in-house broker. Mr Oelssner became a member of the Executive Board of the captive insurance and reinsurance companies of Lufthansa in 2000 and served as Chairman of the International Air Transport Association ("IATA") in 1982 and 1983 and as Chairman of the IATA Risk & Insurance Managers' Panel in 2001 and 2002. He was Chairman and President of Airline Mutual Insurance, Bermuda from the foundation until the dissolution of the Company. He is President of the German Risk Managers' Association. He holds an M.A. in Economics from Cologne University.

Robert Spass (age 52)
Non-Executive Director
Robert Spass is a Partner of Union Square Partners, an investment firm he joined as a founding partner upon its formation in February 2007. He previously held similar positions at Capital Z Partners (which he joined as a founding partner in 1998), and before that at Insurance Partners, L.P. and International Insurance Advisors L.P. Mr Spass currently serves on the Board of Directors of Universal American Financial Corp., Endurance Specialty Holdings, Ltd. and other privately-held companies.

William Spiegel (age 45)
Non-Executive Director

William Spiegel is a founding partner of Pine Brook Road Partners, LLC, a private equity firm specialising in energy and financial services investing. Mr Spiegel has worked in the private equity industry since 1990 at Lehman Brothers and the Cypress Group.

Mr Spiegel has a B.Sc. in Economics from The London School of Economics, an M.A. in economics from the University of Western Ontario and an M.B.A. from the University of Chicago. Mr Spiegel has served on the Board of many private and public companies.

Barry Volpert (age 48)
Non-Executive Director

Barry Volpert is co-founder, Chairman and Chief Executive Officer of Crestview Capital Partners, LP a private equity firm. Prior to founding Crestview Capital Partners, LP he was a partner at Goldman, Sachs & Co., where he was most recently head of the Merchant Banking Division in Europe, co-Chief Operating Officer of the Principal Investment Area worldwide and a Director of Goldman Sachs International. He has a J.D. and M.B.A. from Harvard and received an A.B. from Amherst College. He has served on the Boards of many public and private companies.

Executive Directors

Richard Brindle (age 45)
Chief Executive Officer

Richard Brindle was the driving force behind the establishment of Lancashire in late 2005 and serves as a member of the Lancashire Board. Mr Brindle joined Ascot Underwriting Agency in 2001 as a non-executive member of the Ascot Board, which was a position he held until his resignation in September 2005. As part of his directorship duties at Ascot, Mr Brindle was responsible for a number of independent underwriting reviews and was Chair of the Strategic Business Development Committee. Mr Brindle started his career in 1984 working at Posgate and Denby Managing Agency which was later taken over by Charman Underwriting Agencies. In 1989 Mr Brindle was appointed as Deputy Underwriter of Syndicate 488. In 1991 he was appointed as a Director of Charman Underwriting Agencies and acted as main underwriter until 1999. Mr Brindle left Charman Underwriting Agencies when it was sold to the ACE Group of Companies in Bermuda.

Simon Burton (age 37)
Deputy Chief Executive Officer
and Chief Operating Officer

Simon Burton joined Lancashire in March 2006 and leads the Bermuda subsidiary Lancashire Insurance Company Limited. He also serves as a member of the Lancashire Board. Mr Burton previously spent 10 years at Financial Solutions International ("FSI"), an underwriting division of the ACE Group of Companies that specialised in non-traditional products including insurance, reinsurance, retrocessional and retrospective risks. He has held various roles within FSI, his most recent being President of the unit with responsibility for underwriting, operations and financial performance of FSI offices in Bermuda, London, Dublin and Sydney. Prior to joining ACE, Mr Burton was a consulting actuary at Tillinghast-Towers Perrin in London and Bermuda.

Neil McConachie (age 35)
Chief Financial Officer and
Chief Risk Officer

Neil McConachie joined Lancashire in February 2006 to lead the finance and risk functions of the Group and serves as a member of the Lancashire Board. Mr McConachie was previously Treasurer and Chief Accounting Officer of Montpelier Re Holdings Ltd. Mr McConachie has extensive experience in debt and equity capital markets transactions in the UK and the U.S. including the Initial Public Offerings of Lancashire and Montpelier. Prior to joining Montpelier, Mr McConachie worked for PricewaterhouseCoopers in London and Bermuda and at Stockton Reinsurance Limited.

Company Secretary

Greg Lunn
Group General Counsel

Greg Lunn joined Lancashire in February 2006 and is responsible for all legal affairs. Mr Lunn spent almost 9 years with the ACE Group of Companies, most recently at ACE Limited in Bermuda where he was Compliance Counsel. Between 2000 and 2003 Mr Lunn was Legal Counsel for ACE European Group in London. His responsibilities included the reviewing of legal service requirements for ACE Europe and provisions of European and English law legal advice on a wide range of strategic and transactional issues affecting the ACE European Group, including the implementation of the UK Financial Services and Markets Act 2000.

Senior Management
Bermuda Operations

Sylvain Perrier
Group Chief Actuary

Sylvain Perrier joined Lancashire in March 2006 to lead the Group's actuarial efforts and provide critical support to the Lancashire underwriting team and finance functions. Mr Perrier previously spent 4 years as an actuary at Arch Re, where he reported to the Chief Actuary and CEO in Bermuda. His assignments at Arch Re included reserving, pricing and portfolio risk analysis. Mr Perrier was also responsible for implementation of controls surrounding the actuarial function including compliance with the U.S. Sarbanes-Oxley legislation. Before joining Arch Re, he worked for 8 years as an actuarial consultant for Tillinghast-Towers Perrin on various assignments including pricing and rate filings, reserving and Dynamic Financial Analysis.

Charles Mathias
Group Underwriting Operations Director

Charles Mathias joined Lancashire in November 2005 and is responsible for the underwriting function. Mr Mathias has over 24 years of experience as an underwriter and broker, having previously worked for Leslie and Godwin, Alexander Howden and even opening a reinsurance brokerage for an A&A affiliate in Mexico. In 1991 he was appointed Senior Vice President of an MGA based in Texas underwriting property business throughout Latin America and the Pacific Rim and was responsible for all aspects of production, administration and underwriting of the portfolio. Mr Mathias returned to London in a broking role and most recently worked on property and specialty business for RK Harrison.

Senior Management
London Operations

Paula Porter
Chief Executive Officer – Lancashire Insurance Company (UK) Limited

Paula Porter joined Lancashire in January 2006 and leads the Group's UK operating subsidiary. Mrs Porter has over 26 years experience in the insurance industry having previously worked for Sedgwick Insurance Brokers as Managing Director until 1999 when she moved to Houston Casualty Company in London as Senior Property Underwriter for the start-up London office of that company. While at Houston Casualty Mrs Porter was responsible for underwriting a U.S. and International open market book; primarily for Fortune 500 companies.

Alex Maloney
Chief Underwriting Officer – Lancashire Insurance Company (UK) Limited

Alex Maloney joined Lancashire in December 2005 and leads Lancashire's UK underwriting operations. Mr Maloney built the energy business and team for the Lancashire Group after joining from Zurich where he spent 15 years. His team at Zurich wrote, amongst others, insurance for independent oil and gas companies and national oil companies, both key classes for Lancashire. Mr Maloney assisted in establishing Zurich Global Energy's presence in the Bermuda Insurance market, spent 2 years in Zurich's New York office and has significant experience in the London Market.

Senior Management
Dubai Operations

John Melcon
Chief Executive Officer – Lancashire Marketing Services (Middle East) Limited

John Melcon joined Lancashire in January 2007 to head up Lancashire's Middle East operations. Mr Melcon has over 35 years experience in the international insurance and reinsurance markets including 8 years based in the Middle East most recently as General Manager of Al Khazna Insurance Company in the UAE. Prior to this he established Falcon Reinsurance Services & Addison Bradley (Financial Services) Ltd. in London and later joined the St Paul Inc. as Regional Manager for business development in developing countries. Mr Melcon then went on to join United Insurance Brokers as their Account Executive for the Middle East and South Asia, and is a fluent Arabic speaker.

Company details

Martin Thomas	(Non-Executive Chairman)
Jens Juul	(Non-Executive Director)
Ralf Oelssner	(Non-Executive Director)
Robert Spass	(Non-Executive Director)
William Spiegel	(Non-Executive Director)
Barry Volpert	(Non-Executive Director)
Richard Brindle	(Chief Executive Officer)
Simon Burton	(Deputy Chief Executive Officer and Chief Operating Officer)
Neil McConachie	(Chief Financial Officer and Chief Risk Officer)

Business address	Mintflower Place, 8 Par-la-Ville Road, Hamilton HM 08, Bermuda
Registered Office	Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda
Company Secretary	Greg Lunn
Principal Bankers	The Bank of Bermuda, 6 Front Street, Hamilton HM 11, Bermuda
Registrar	Capita Registrars (Jersey) Limited, P.O.Box 532, St Helier, Jersey JE4 5UW
Depositary	Capita IRG Trustees Limited, The Registry, 34 Beckenham Road, Beckenham, Kent BR3 4TU, England
Legal Counsel (Bermuda)	Conyers Dill & Pearman, Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda
Legal Counsel (UK and U.S.)	Dewey & LeBoeuf, No. 1 Minster Court, London EC3R 7YL, England
Auditors	Ernst & Young, Reid Hall, 3 Reid Street, Hamilton HM 11, Bermuda

Directors' report

status of the company
Lancashire is a Bermuda incorporated company with operating subsidiaries in Bermuda, London and Dubai. The Company's shares were admitted to trading on AIM in December 2005.

principal activities and review of business
The Company's principal activity, through its wholly owned subsidiaries, is the provision of global property insurance and reinsurance products. Further discussion of the Company's principal activities and business during 2007 is contained in the statements of the Chairman, CEO and the review of results and outlook.

dividends
A strategic dividend of $1.10 per common share and vested warrant was declared on December 10, 2007. The dividend was paid on January 25, 2008 in pounds sterling (£0.5622 per common share) using the pound/US dollar exchange rate of 1.9566 derived on the record date of January 11, 2008.

directors
The names and dates of appointment of the Directors who served during 2007 are set out in the Corporate Governance section of this report. Biographical information for all the Directors is included in the description of The Team set out earlier in this Annual Report.

directors' interests
The Directors' beneficial interests in the Company's common shares as at December 31, 2006 and December 31, 2007 including interests held by family members were as follows:

director	common shares held at december 31, 2006	common shares held at december 31, 2007
Martin Thomas	Nil	6,950
Jens Juul	Nil	10,000
Ralf Oelssner	Nil	Nil
Robert Spass	272,500	272,500
William Spiegel	63,240	70,240
Barry Volpert	Nil	Nil
Richard Brindle	300,000	300,000
Simon Burton	Nil	240,000
Neil McConachie	20,000	47,500

On March 4, 2008 Robert Spass purchased 100,000 common shares at an average purchase price of £2.97106, after which he held 372,500 common shares.

Between February 18 and February 21, 2008 Richard Brindle purchased 44,115 common shares at an average purchase price of £3.066 and on February 21 and 22, 2008 purchaed 48,630 common shares at an average purchase price of £3.08, after which he held 392,745 common shares.

Warrants over the Company's shares were awarded to the Company's founders prior to the admission of the Company's shares to trading on AIM ("initial founders' warrants"). Richard Brindle holds 46,260, Robert Spass holds 1,549,135 and William Spiegel holds 481,182 initial founders' warrants.

In addition to the Directors' interests set out above, Barry Volpert is co-founder, Chairman and CEO of Crestview Capital Partners, LP which is interested in 15,000,000 shares in the Company and 1,183,180 initial founders' warrants.

Richard Brindle, Simon Burton and Neil McConachie, the Company's executive Directors also hold share options and management warrants as part of their remuneration packages. Further details are included in the Directors' Remuneration Report.

transactions in own shares

The Company repurchased 446,422 of its common shares with a nominal value of U.S.$0.50 per share in accordance with the cashless exercise procedure for certain management and initial founders' warrants. 127,087 warrants were exercised on April 25, 2007 and 500,000 warrants were exercised on August 14, 2007. 94,447 common shares were repurchased effective April 25, 2007 and 351,975 common shares were repurchased effective August 14, 2007 for an aggregate deemed consideration of $3,135,447 based on market value and in accordance with the terms of the warrants. The repurchased shares were cancelled as at April 25, 2007 and August 14, 2007 respectively.

In addition the Company repurchased and cancelled 13,640,916 of its own common shares from November 2007 through December 2007 as part of its $100 million share repurchase programme approved by the Board in accordance with the Company's bye-laws and announced on October 29, 2007.

directors' remuneration

Details of the Directors' remuneration are set out in the Directors' Remuneration Report.

substantial shareholders

As at March 7, 2008 the Company was aware of the following interests of 3 per cent or more in the Company's issued share capital:

name	number of shares as at march 7, 2008	% of shares in issue
Crestview Capital Partners, LP	15,000,000	8.2
Caisse de Dépôt et Placement du Qúebec	14,961,242	8.2
Frank W. Cawood & Associates	9,808,002	5.4
BlackRock Merrill Lynch Investment Mgrs.	8,616,832	4.7
Steadfast Capital LP	8,564,154	4.7
Artisan Partners	7,093,272	4.3
Oaktree Capital Management, LLC	6,050,000	3.3
Franklin Resources, Inc.	5,760,431	3.2

corporate governance
The status of the Company's compliance with the UK Combined Code on Corporate Governance is set out in the Corporate Governance section of this report.

donations
In 2007 the Company established and funded the Lancashire Foundation, a Bermuda charitable trust, for the benefit of charitable causes in Bermuda and elsewhere. The Foundation's trustee is an independent third party professional trust company that makes donations following recommendations made by a Donations Committee consisting of Group employees and related interested parties. Specific criteria have been set for the Foundation's charitable giving. These include recognised community problems requiring action, the opportunity to make an impact that is measurable and lasting, and projects that lend themselves to proactive involvement by members of the Donations Committee and Group staff members. The Donations Committee also looks at opportunities to partner with other charities/donors subject to retaining the ability to maintain reasonable control and ensure outcome goals are met. Charities which the Foundation has supported in 2007 and has committed to support in 2008 include The Family Centre, the Bermuda Autism Support and Education Society, the Sunshine League, and a number of others.

In 2007 the Group also made a charitable donation that will support emissions reduction projects around the world using standards that meet the proposed UK Government's Code of Best Practice (for further information see the "Environment" paragraph below).

The Group did not make any political donations or expenditure during 2007.

health and safety
The Group considers the health and safety of its employees to be a management responsibility equal to that of any other function. The Group operates in compliance with health and safety legislative requirements in Bermuda, Dubai and the UK.

employees
Lancashire is an equal opportunity employer, and does not tolerate unfair discrimination of any kind in any aspect of employment, including retirement, recruitment, training, promotion, compensation, benefits, advancement and career development. The Group believes that education and training for employees is a continuous process and employees are encouraged to discuss training needs with their managers. The Group's health and safety, equal opportunities, training and other policies are available to all employees in the staff handbook which is on the Group's intranet.

environment
The Group has a strong commitment to the environment and is "Carbon Positive". The Group's office emissions have been calculated by PURE the Clean Planet Trust (UK registered charity No. 1112249) and the carbon emissions associated with the energy usage in Lancashire's offices in Bermuda, Dubai and London have been offset with PURE.

In offsetting with PURE, the Group has made a charitable donation that will support emissions reduction projects around the world using standards that meet the proposed UK Government's Code of Best Practice.

In addition, all carbon emissions resulting from the Group's business travel are offset with Climate Care.

LICUKL is also a founding supporter of the London City Climate Pledge. The goal of the London City Climate Pledge is to develop projects that verifiably reduce carbon emissions and which demonstrably benefit local communities by increasing incomes and improving quality of life. The London City Climate Pledge is administered by PURE.

Lancashire's decision to be a founding member of the London City Climate Pledge further demonstrates the Group's commitment to supporting robust emission reduction projects.

creditor payment policy
The Company aims to pay all creditors promptly and in accordance with contractual and legal obligations.

financial instruments and risk exposures
Information regarding the Group's risk exposure is included in the risk disclosures in the consolidated financial statements. The Group's use of derivative financial instruments can be found at note 20 of the consolidated financial statements.

accounting standards
The Group's consolidated financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS") endorsed 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, management determines appropriate measurement bases, to provide the most useful information to users of the consolidated financial statements, using their judgement and considering the accounting principles generally accepted in the United States ("U.S. GAAP").

2008 annual general meeting
The Company's annual general meeting is scheduled for 1.00pm on April 30, 2008 at the Company's offices, Mintflower Place, 8 Par-la-Ville Road, Hamilton HM 08, Bermuda. Notice of the annual general meeting and the form of proxy accompanies this Annual Report.

going concern
The Board is satisfied that the Company has adequate resources to continue in operation for the foreseeable future. The Company's consolidated financial statements therefore continue to be prepared on a going concern basis.

auditors
Resolutions will be proposed at the Company's annual general meeting to re-appoint Ernst & Young as the Company's auditors and to authorise the Directors to set the auditors' remuneration. Ernst & Young have served as the Company's auditors since 2005.

Approved by the Board of Directors and signed on behalf of the Board.

Greg Lunn, Company Secretary
March 7, 2008

Corporate governance

Lancashire intends to comply with the UK Combined Code on Corporate Governance published in July 2003 and revised in 2006 ("Combined Code") although, as an AIM company, it is not required to do so. Currently, the Company complies with the Combined Code except as stated in this Corporate Governance section and in the Directors' Remuneration Report section of this Annual Report. There are no Bermudian corporate governance standards similar to the Combined Code that apply to Lancashire.

directors

As at December 31, 2007 the Directors of the Company and their dates of appointment were as follows:

director	position	date of appointment as director
Martin Thomas	Non-executive Director (Chairman from May 1, 2007)	September 15, 2006
Jens Juul	Non-executive Director	November 16, 2007
Ralf Oelssner	Non-executive Director (Senior Independent Director from May 1, 2007)	December 9, 2005
Robert Spass	Non-executive Director (Chairman until May 1, 2007)	December 16, 2005
William Spiegel	Non-executive Director	December 16, 2005
Barry Volpert	Non-executive Director	December 16, 2005
Richard Brindle	Chief Executive Officer	October 13, 2005
Simon Burton	Deputy Chief Executive Officer and Chief Operating Officer	November 16, 2007
Neil McConachie	Chief Financial Officer and Chief Risk Officer	December 9, 2005

In accordance with the Company's bye-laws, the Directors are divided into class I, II and III Directors who hold office until the 2009, 2008 and 2010 annual general meetings respectively. At these meetings the relevant Directors may be re-elected by the Company's shareholders for further three year terms. The class III Directors, Neil McConachie and Martin Thomas, were re-appointed at the 2007 annual general meeting held on May 1, 2007 to hold office until 2010. Richard Brindle, Simon Burton and Barry Volpert are the Class II Directors and will accordingly be submitting themselves for re-election by the Company's shareholders at the annual general meeting scheduled to take place on April 30, 2008 as detailed in the notice of annual general meeting accompanying this report.

independence

Jens Juul, Ralf Oelssner and William Spiegel are independent Directors as each is independent in character and judgement and has no relationship or circumstance likely to affect his judgement. Martin Thomas was independent upon his appointment as Chairman on May 1, 2007. Robert Spass and Barry Volpert are not independent under the Combined Code due to their appointment by and affiliation with specific shareholders.

Accordingly, three out of the nine members of the Board are independent non-executive Directors and the Board composition does not currently comply with the Combined Code requirement that independent non-executive Directors should make up at least half of the Board. However the Board's present composition is appropriate for the current stage of the Company's development. The Company will appoint additional Directors during 2008 and is actively pursuing suitable candidates.

board

The Board has overall responsibility for the leadership and control of Lancashire's business. The Board has reserved a number of matters for its decision including responsibility for the overall management of the Group and approval of the Group's long-term objectives and commercial strategy. The Board has delegated certain matters to the committees described below. The committees report to the Board.

The Board has separate appointments for the roles of Chairman and Chief Executive Officer and adopted a formal division of responsibilities for these positions during 2007. The day to day management of the Company and implementation of Board decisions and strategy is carried out by the executive Directors and senior management. The Board of Directors meets on a quarterly basis and occasionally more frequently as circumstances dictate. At these meetings, the Board reviews all areas and developments in the Group's business and receives reports from management on finance, underwriting and any other key matters affecting the Company. The Board is provided with information necessary for it to fulfill its responsibilities including quarterly reports and full board papers. Additional information is provided to the Board as and when necessary and the Directors have access to independent professional advice as required.

The Directors' attendance at the Board meetings held in 2007 is as follows:

director	meetings held while a director	meetings attended while a director
Martin Thomas	6	5
Jens Juul	1	1
Ralf Oelssner	6	5
Robert Spass	6	4
William Spiegel	6	3
Barry Volpert	6	4
Richard Brindle	6	4
Simon Burton	1	1
Neil McConachie	6	6

For 2007 the Board had scheduled four meetings, each spanning (including Sub-Committees) two days. In addition, there were two further Board Meetings convened at short notice to address specific issues relating to capital management where the Company's approach is to be nimble and to react to circumstances as they arise.

The Chairman's other significant commitments are periodically considered by the Board, as are changes to the Chairman's and other Directors' time commitments.

information and training

On appointment the Directors receive written information regarding their responsibilities as Directors. Information regarding the Company's AIM and Bermuda law obligations and on the Combined Code is also provided. All the Directors have access to the Company Secretary who is responsible for updating the Board with any legal, regulatory or compliance developments affecting the Company. The Directors also have access to independent legal advice as required.

The new Director induction process includes meeting with senior management, visiting the Company's operations and the provision of key information.

board performance evaluation

The first evaluation of Board performance was carried out in the second half of 2007, and was conducted by external specialists. The Board as a whole, the committees and the individual Directors were evaluated.

During the evaluation process, all Directors, the Company Secretary and certain other senior executives were given the opportunity to give their views on the effectiveness of the Board and its committees, particularly by identifying any shortcomings in procedures, working methods or any other areas of weakness requiring attention and improvement. In addition, the performance of the Chief Executive Officer was appraised by the Chairman and the performance of the executive team by the Chief Executive Officer.

The results of the survey were reviewed and evaluated by the nomination and corporate governance committee, and subsequently by the Board. On the evidence provided the Board and its committees are satisfied with the overall effectiveness and balance. As a result of the process, as well as continuing with the search for additional non-executive Directors identified earlier, the Board will be focusing on succession planning in 2008.

relations with shareholders

Throughout 2007, management talked with several of the Company's major shareholders and met with the investor community. Feedback from analysts following presentations was reported to the Board in 2007. Conference calls have been held following announcement of the Company's financial results. The Company has also commissioned shareholder reports to review the make up of its beneficial shareholder base. The Company's Chairman and the non-executive Directors are also available to meet with major shareholders at the Company's annual general meeting and throughout the year. Shareholders are encouraged to attend the Company's annual general meeting and to vote on shareholder resolutions. Leading up to the 2007 annual general meeting the Company contacted several major shareholders to encourage proxy returns.

On December 3, 2007 the Company issued a notice of special general meeting of shareholders to be held on January 4, 2008. After the notice was issued, telephone calls were made to the Company's significant shareholders to explain the proposals and all resolutions were duly passed.

committees

The Board has established nomination and corporate governance, audit, remuneration, investment and underwriting committees. The committees' responsibilities are contained in their terms of reference and their reporting obligations are to the Board. The committees are generally scheduled to meet quarterly prior to the Board meetings at which they report. The composition of the committees as at December 31, 2007 was as follows:

	nomination and corporate governance	audit	remuneration	investment	underwriting
Martin Thomas	✓(chair)		✓		✓
Jens Juul					
Ralf Oelssner		✓	✓		✓
Robert Spass	✓	✓ (chair)			
William Spiegel		✓	✓(chair)	✓(chair)	
Barry Volpert	✓			✓	
Richard Brindle	✓				✓ (chair)
Simon Burton					✓
Neil McConachie				✓	

nomination and corporate governance committee

The members of the nomination and corporate governance committee during 2007 were Robert Spass (Chair), Richard Brindle and Barry Volpert. Martin Thomas joined the committee and replaced Robert Spass as committee Chairman on May 1, 2007. The composition of the committee currently does not conform to the Combined Code requirement that a majority of the nomination and corporate governance committee should be independent non-executive Directors. However the Board considers that the current composition is appropriate considering Lancashire has been in its second year of operations. The Board intends to review the nomination and corporate governance committee membership again in 2008. The nomination and corporate governance committee met four times during 2007. All members attended all meetings held in 2007 while they were members of the nomination and corporate governance committee.

The nomination and corporate governance committee's responsibilities are contained in their terms of reference. These include reviewing the structure, size and composition (including the skills, knowledge and experience) of the Board and making recommendations regarding changes. In November 2007 the nomination and corporate governance committee recommended the appointment of Jens Juul to the Board as an additional independent non-executive Director and in early 2008 will consider his further appointment to Board committees. The Company used an external search agency for Mr Juul's appointment and has appointed a further search agency to assist in the search for additional non-executive Directors during 2008.

audit committee

The members of the audit committee during 2007 were Robert Spass (Chair), Ralf Oelssner and William Spiegel. Martin Thomas ceased to be a committee member when he replaced Robert Spass as the Company's Chairman on May 1, 2007. The Board considers that Robert Spass has recent and relevant financial experience. Since May 1, 2007, as a result of Robert Spass ceasing to be Chairman of the Company and following Martin Thomas' cessation of audit committee membership, the composition of the audit committee has conformed with the Combined Code. The audit committee met four times during 2007. Ralf Oelssner and William Spiegel each missed one audit committee meeting in 2007. All other audit committee members attended all the meetings held during 2007 while they were members.

The audit committee is responsible for the effectiveness of the internal and external audit functions. The audit committee's responsibilities are contained in their terms of reference. These include reviewing and reporting to the Board on the preparation of the Company's financial information, announcements relating to the Company's financial results and monitoring the independence of the Company's auditors. Key work carried out by the audit committee during 2007 is detailed in the Internal Control section of this report.

remuneration committee

The members of the remuneration committee during 2007 were William Spiegel (Chair), Ralf Oelssner and Martin Thomas. The remuneration committee met seven times in 2007 and each of the members missed one remuneration committee meeting and attended six meetings.

The remuneration committee's responsibilities are contained in their terms of reference. These include determining remuneration for the Company's executives and senior management of the Group within a framework agreed with the Board. During 2007 the remuneration committee considered and approved the award of options under the Company's long-term incentive plan. In November 2007 the remuneration committee also recommended to the Board that the Company's long-term incentive plan be amended to provide that the remuneration committee, as it may deem appropriate, may adjust the number of common shares comprised in, and/or the exercise price of the options, on the payment of any dividends by the Company in order to neutralise the devaluing impact of such dividend payments on the value of the options. The Board subsequently recommended this amendment to shareholders, who approved it at the special general meeting which was held on January 4, 2008.

The amendments to the long-term incentive plan were made effective retrospectively from the date of the notice of special general meeting, December 3, 2007, so that the new provisions will apply to any special or strategic dividends with a record date on or after that date. In addition, following shareholder approval of this proposal and approval of a restricted share scheme, the long-term incentive plan will be closed to further awards.

Having consulted with external advisers, the remuneration committee also recommended to the Board the introduction of a new restricted share scheme incentive arrangement under which group employees and executive Directors will be awarded shares subject to time and, normally, performance vesting conditions. The restricted share scheme was also approved by the Company's shareholders on January 4, 2008. In future, the restricted share scheme will replace the long-term incentive plan in relation to future equity awards to employees and executives. The purpose of the restricted share scheme awards will be to motivate and retain certain individuals who are responsible for the attainment of the primary long-term performance goals of the Company and its subsidiaries.

A full report of the Directors' remuneration is included in this Annual Report.

investment committee

The members of the investment committee during 2007 were William Spiegel (Chair), Neil McConachie and Barry Volpert. The investment committee's responsibilities are contained in its terms of reference. These include recommending and monitoring investment strategies, recommending appointments of fund managers for the Group's investments and monitoring the cash flow, liquidity and working capital of the Group. During 2007, the investment committee recommended revised investment guidelines for adoption by the Board and monitored the Group's investment performance. The investment committee met four times during 2007. William Spiegel attended three meetings and the other investment committee members attended all the meetings held during 2007.

underwriting committee

The members of the underwriting committee during 2007 were Richard Brindle (Chair), Ralf Oelssner, Martin Thomas and representatives of the Group's underwriting team (including representatives of LICL and LICUKL). Simon Burton, already a non-director member of the underwriting committee, became a Director of the Company in November 2007. The underwriting committee's responsibilities are contained in its terms of reference. These include reviewing and monitoring compliance with the Group's underwriting guidelines and policies, formulating underwriting strategy, reviewing aggregate underwriting exposures and reviewing compliance with Probable Maximum Loss limits. During 2007 the underwriting committee recommended revised underwriting guidelines for the Group and reviewed the Group's underwriting activities in light of the Group's overall strategy and business plan. The underwriting committee met four times during 2007. Ralf Oelssner attended three meetings and the other underwriting committee members attended all the meetings held during 2007 while they were members.

internal controls

The Board is responsible for maintaining a robust framework of internal control and risk management and for overseeing and ensuring the effectiveness of the Group's risk and control processes. The Board has delegated responsibility to the audit committee for reviewing the Group's internal control and financial reporting systems (including financial, operational, compliance and risk management). These systems are designed to promptly identify significant risks facing the Company so that such risks remain within the tolerance levels agreed by the Board. The Board acknowledges that the Company cannot eliminate all risks, but believes that comprehensive assessment and management of the risks facing the Company enables the business to operate within acceptable levels of risk. The audit committee reports, and makes recommendations, to the Board regarding the effectiveness of internal controls and its risk management policies and procedures. During 2007 the audit committee reviewed the effectiveness of the Company's internal controls and risk management systems, reviewed the Company's financial reporting, and held closed sessions respectively with the Company's internal and external auditors and with management.

internal audit and risk assessments

In 2007, on the recommendation of the audit committee, the Company renewed the engagement of a third party professional internal audit services firm ("internal audit firm") which carried out internal audits and reported on the Company's internal controls and processes in respect of entity-level controls, policies and procedures, claims processes, actuarial reserving, aggregation of risk, underwriting compliance, information technology change management and security compliance, management and financial reporting, and compliance with tax operating guidelines. In addition, the comprehensive risk assessment conducted during 2006 and 2007 was updated at the end of 2007 and in early 2008. The risk assessment was used as a basis for developing the 2007 internal audit plan. Findings of the internal audits have been reviewed by the audit committee and the Board and the Company is implementing the recommendations made.

At the end of 2007 the Company appointed a group internal auditor and risk manager as a member of its full time staff. As well as conducting internal audits, the group internal auditor and risk manager will manage the ongoing use of the internal audit firm, which will continue to be retained to assist with risk reviews and to carry out internal audits in areas where specialist third party audit knowledge and resources are required.

external audit and provision of non audit services

The audit committee is responsible for reviewing and monitoring the external auditors' objectivity and reporting to the Board to ensure that the auditors' objectivity and independence is safeguarded. The Board is responsible for reviewing the effectiveness of the external audit which is reported on by the audit committee. Following on from work carried out in 2006, in 2007 Ernst & Young performed certain limited non-audit services in relation to the commencement of the Group's UK underwriting operations. During 2007, the audit committee monitored the provision of these services. The audit committee and the Board are currently satisfied with the objectivity and independence of the auditors.

enterprise risk management

A Group Chief Risk Officer was appointed in 2007 and, building on the investment made in this area in 2006 together with the ongoing support of the internal audit firm, the Group has continued to embed and enhance enterprise risk management within its operations and systems. All key processes within the Group's businesses have been documented including the associated risks and controls. In 2007 the Group extensively reviewed its risk registers and is satisfied that all of the key business risks, and the controls that mitigate them, have been identified, classified, evaluated and ranked against one another. This has enabled the Group to improve implementation of its existing risk management framework and the effective operation of the Group's risk management processes. The monitoring and evaluation of management's risk management activities by the group internal auditor and risk manager will add additional strength in this area.

directors' remuneration report

Because Lancashire's shares are admitted to trading on AIM, the Directors' Remuneration Report Regulations 2002 do not apply to it. However, the Board is committed to providing information to shareholders and complying with corporate governance standards and best practices to the appropriate extent. The Company therefore uses the disclosure requirements set out in the Regulations as guidelines for its disclosures in relation to the Directors' remuneration.

remuneration committee

The members of the remuneration committee during 2007 were William Spiegel (Chair), Ralf Oelssner and Martin Thomas. Details of the remuneration committee's terms of reference and its work are set out in the corporate governance section of this Annual Report.

advice to the remuneration committee

During 2007, New Bridge Street Consultants LLP ("NBSC") and Frederic W. Cook & Co., Inc. ("FWCook") were appointed by the remuneration committee to give advice on market trends, practices and appropriate levels of remuneration for executive and non-executive Directors. NBSC also advised the remuneration committee on the structure and implementation of the Company's restricted share scheme which was approved by the Company's shareholders on January 4, 2008. Greg Lunn, the Company Secretary, and Dewey & LeBoeuf LLP, the Company's legal counsel, provided the remuneration committee with advice in relation to remuneration matters including the operation of the Company's share schemes. Dewey & LeBoeuf LLP provided other legal services to the Group during 2007. NBSC and FWCook did not provide any other services to the Company during 2007.

remuneration policy for non-executive directors

Lancashire's policy for the non-executive Directors' and Chairman's remuneration is to set fees at an appropriate level so as to attract individuals with the range of skills and experience suitable for an international insurance group of Lancashire's size and complexity. Other listed international insurance companies are the primary pay comparator group. The Chairman and the non-executive Directors receive no benefits in addition to their fees and do not participate in any incentive or performance plans or pension arrangements. The Company encourages share ownership by the Chairman and non-executive Directors and non-executive Directors who do not own shares are encouraged to use a proportion of their fees to buy shares in the Company and retain such shareholdings for their remaining periods of office.

terms of appointment of non-executive directors

The non-executive Directors serve under letters of appointment and are appointed for a period of three years terminable by either party on six months notice. The non-executive Directors are typically expected to serve twice for three year terms although the Board may invite a non-executive Director to serve for an additional period. Their terms of office are set out in the corporate governance section of this Annual Report and their letters of appointment are available for inspection at annual general meetings.

remuneration of non-executive directors

Prior to May 1, 2007 each non-executive Director of the Company received an annual fee of $85,000 for their Board appointment. The Chairman of the Board received an additional $15,000. In addition $15,000 per annum was paid for chairmanship of the audit committee, $5,000 for chairmanship of the remuneration and investment committees and $2,000 was paid for each Board or committee meeting attended.

During April 2007, the Board reviewed the fees of the non-executive Directors, including the Chairman, with advice from NBSC and FWCook regarding market practice in appropriate comparator companies. Following the review, since May 1, 2007 the Director's meeting attendance fees were dispensed with and a basic non-executive Director's fee of $140,000 per annum was applied. In addition a further fee of $35,000 per annum was applied to each of the Senior Independent Director and the Chairman of the Audit and the Remuneration Committees. A flat fee of $275,000 per annum was set for the Chairman of the Board.

In addition to the above fees, in 2007 LICUKL paid annual fees for appointments as non-executive Chairman and non-executive Director of LICUKL. Prior to May 1, 2007 $50,000 per annum was paid to the LICUKL Chairman and $30,000 per annum was paid to other non-executive Directors. In addition the LICUKL Chairman and each LICUKL non-executive Director received $2,000 for each LICUKL Board or committee meeting attended and $5,000 per annum for chairmanship of a LICUKL Board committee. Since May 1, 2007 a flat fee of $100,000 per annum was applied to the Chairman of LICUKL, which included fees for chairmanship of the risk and audit committees and excluded attendance fees, which ceased to be payable to the LICUKL Chairman. Martin Thomas serves as Chairman of LICUKL and Ralf Oelssner serves as a non-executive Director.

Details of the payments made to the individual Directors in 2007 are set out in the Directors' Emoluments paragraph below. The non-executive Directors received no other remuneration in 2007.

remuneration policy for executive directors

The Company's policy is to create remuneration packages that will enable it to recruit and maintain suitably experienced individuals. To this end, the Board in 2007 adopted a framework for executive Director remuneration setting out its policy in greater detail.

executive directors service contracts

The executive Directors' remuneration was made up of the following elements which are set out in detail below:

- base salary;
- basic bonus;
- additional bonus linked to the Company's performance;
- share options and restricted shares;
- performance warrants;
- time-vesting warrants;
- pension;
- benefits, including medical, dental, vision coverage, air travel and housing and other allowance for expatriates.

The Company's remuneration philosophy is that executive and employee remuneration packages should include an appropriate incentive based element as considered reasonable and necessary to drive individual performance and to fairly reward the executive Directors and staff for their contribution to the successful performance of the Company. The addition of bonuses should position the cash element of remuneration at or near the top of the range when compared to peer companies generating similar returns. There should be a programmatic and principled scheme of remuneration, including properly articulated goals against which to benchmark that part of remuneration that relates to individual performance. Bonuses are based on a clear split between the Company's financial performance as well as the defined individual goals.

Variable elements of executive Directors' remuneration are designed to align interests with shareholders through linking rewards to shareholder returns and strong financial performance. The design of the performance conditions are set out in more detail in the descriptions below of the bonus plans, performance warrants and the new restricted share scheme.

Awards under the Company's long-term incentive plan, and the ordinary warrants, are time-vesting and do not contain performance conditions. These elements of the executive Directors' remuneration have been aimed at securing retention of key individuals during the start and early stages of Lancashire's operations. The long-term incentive scheme has now been closed for new awards and replaced by a restricted share scheme under which awards will, normally, be subject to performance conditions.

Richard Brindle was appointed as Chief Executive Officer and Chief Underwriting Officer under a service contract dated December 9, 2005. Neil McConachie was appointed as Chief Financial Officer under a service contract dated February 1, 2006. Simon Burton was appointed Deputy Chief Executive Officer under a service contract dated January 1, 2007. Richard Brindle's, Simon Burton's and Neil McConachie's service contracts are for terms of three years after which they may be extended by agreement. As at December 31, 2007, the unexpired term of both Richard Brindle's and Neil McConachie's service contracts is approximately one year, and the unexpired term of Simon Burton's contract is approximately two years. All service contracts contain six month notice provisions. Richard Brindle is also employed by the Group's UK operations under a service contract dated December 12, 2005. This service contract is also for a term of three years after which it may be extended by agreement and contains a six month termination provision. As at December 31, 2007 the unexpired term of this service contract is approximately one year. Details of the salaries payable under these contracts are set out in the emoluments table at the end of this Directors' Remuneration Report.

basic bonus plan

The Company operated a basic management bonus plan under which for 2007 there was no minimum bonus. For 2006, the Company's first year of operations, Richard Brindle and Neil McConachie were entitled to a minimum bonus of 75 per cent of base salary, and Simon Burton was entitled to a minimum bonus of 50 per cent of base salary. The maximum bonus payable for 2007 was 400 per cent of base salary (2006 – 250 per cent) for Richard Brindle, 350 per cent of base salary for Simon Burton and 300 per cent of base salary (2006 – 200 per cent) for Neil McConachie. Details of the bonuses awarded to Richard Brindle, Simon Burton and Neil McConachie under this plan are set out in the emoluments table at the end of this Directors' Remuneration Report. In addition, the amounts of annual bonuses in the aggregate under the basic bonus plan and the additional bonus plan (described below) which may be paid to any individual were subject to a maximum amount described in relation to the additional bonus plan below. The actual amount of the bonus paid out by the Company to the executive Directors is determined by the remuneration committee (upon the recommendation of the Chief Executive Officer in respect of the Deputy Chief Executive Officer and Chief Financial Officer) based on individual and corporate performance.

additional bonus plan

In addition to the basic bonus plan, the Company operated an additional bonus plan under which formula-based additional bonuses may be paid to the executive Directors and other eligible employees in addition to the basic bonuses described above. For 2006, the additional bonuses were determined following the publication and review of comparator peer group companies in accordance with the plan.

The amounts payable under the additional bonus plan were based on a formula which reflected both absolute and relative returns for 2006, with each such performance condition/threshold met contributing 50 per cent of the possible sum paid to the individual. Under the additional bonus plan, one half of the bonus was payable under an absolute return pool that comprised 2.5 per cent of the profits generated to the extent the Group's return on equity for that year exceeded the Group's return on equity for that year as projected at the time of the Company's admission to AIM. The other one half of the additional bonus was payable under a relative return pool that comprised 2.5 per cent of the profits generated to the extent the Group's return on equity exceeded the average of a peer group of comparable insurance and reinsurance companies. The allocation of amounts in the pools payable under the additional bonus plan to the Chief Executive Officer was limited to 35 per cent and in addition is subject to the aggregate maximum limits below. The maximum amount payable in the aggregate for 2006 under the combination of the basic bonus plan and the additional bonus plan was 500 per cent of base salary in the case of the Chief Executive Officer and 400 per cent of base salary for the Chief Financial Officer.

The amounts paid to each executive under the additional bonus plan in 2007, in respect of the year ended December 31, 2006 are shown under Directors' emoluments. The additional bonus plan has been closed, and there will be no further payments under this plan.

long-term incentive plan

In 2005, the Board adopted a Long-Term Incentive Plan ("LTIP") (which has not been submitted for approval by HM Revenue & Customs or any other tax authority) to enable any full-time executive Director or employee of the Group (provided that the individual is not within six months of retirement) to be granted share options at the discretion of the remuneration committee. The options are time-vesting and there are no performance conditions to be satisfied before exercise of an option. The options vest as to 25 per cent on each of the first, second, third and fourth anniversaries of the date of grant provided that the option holder remains in the employment of the Group at the relevant anniversary. As disclosed in Lancashire's AIM admission document, the LTIP does not comply with certain provisions of the Combined Code. No options were exercised during 2007 or 2006. Details of the Directors' share options position for 2007 and 2006 are as follows:

name of director	share options at 31/12/2006	share options at 31/12/2007	date of award	price paid	exercise price	exercise date(1)	expiry date	vesting conditions
Richard Brindle	762,522	762,522	9/3/06	nil	£3.25325	9/3/07-9/3/10	8/3/16	time-vesting
		150,000	29/6/07	nil	$6.87	29/6/08-29/6/11	28/6/17	time-vesting
Simon Burton	–	300,000	9/5/07	nil	$7.11	9/5/08-9/5/11	8/5/17	time-vesting
		500,000	29/6/07	nil	$6.87	29/6/08-29/6/11	28/6/17	time-vesting
Neil McConachie	508,348	508,348	9/3/06	nil	£3.25325	9/3/07-9/3/10	8/3/16	time-vesting
		200,000	29/6/07	nil	$6.87	29/6/08-29/6/11	28/6/17	time-vesting

(1) options vest 25 per cent on each of the first, second, third and fourth anniversaries of the date of grant.

Following an amendment to the LTIP as approved by the Company's shareholders at the special general meeting of shareholders held on January 4, 2008 (detailed in the Corporate Governance – Remuneration Committee paragraph above) the Remuneration Committee exercised its discretion to reduce the exercise price for all outstanding vested and unvested options by $1.10 or £0.5622 effective January 9, 2008. The adjustment was made to reflect the strategic dividend declared on December 10, 2007 and paid by the Company in January 2008, and consequent reduction in shareholders' equity.

Following the adoption of the new restricted share scheme (described below) by the Company's shareholders on January 4, 2008, Lancashire has closed the LTIP to further awards.

management warrants

During 2006, the Company allocated time-vesting warrants ("Ordinary Warrants") and performance-vesting warrants ("Performance Warrants") to the executive Directors and other employees of the Group out of warrants approved by the Company's shareholders in 2005 (as detailed in the Company's AIM admission document).

The Ordinary Warrants vested 25 per cent on issuance on the admission of the Company's shares to trading on AIM (December 16, 2005). 25 per cent vested on each of the first and second anniversaries of the admission of the Company's shares to trading on AIM. 25 per cent will vest on the third anniversary of the admission of the Company's shares to trading on AIM; except that the Ordinary Warrants awarded to Richard Brindle will vest immediately on a change of control of the Company or in the event of his dismissal (other than for willful misconduct) as a Director or employee of any Group company. Furthermore the Ordinary Warrants awarded to Simon Burton and to Neil McConachie will vest immediately in the event of their dismissal (other than for willful misconduct) following a change of control of the Company.

The Performance Warrants vest in three tranches, 20 per cent on December 31, 2007, 40 per cent on December 31, 2008 and 40 per cent on December 31, 2009 subject to the Company achieving certain performance conditions. The performance conditions are based on a combination of compound return and fully converted book value targets. For each tranche, 50 per cent will vest if the compound IRR target is met and the other 50 per cent if the fully converted book value target is met. There are minimums established for both targets below which zero warrants will vest. The performance conditions are described in more detail at note 6 of the consolidated financial statements included in this report. For the 2007 tranche, the minimum compound IRR target was not met so zero warrants will vest from this portion, and of the book value portion 94.7% of the warrants will vest. As disclosed in the Company's AIM admission document, the warrants do not comply with certain provisions of the Combined Code.

As a result of the compound IRR target for 2007 not being met Performance Warrants for Richard Brindle, (305,009), Simon Burton, (48,293) and Neil McConachie (76,252) lapsed, as reflected in the table below. The table below does not reflect the lapsing of any book value performance warrants pending the completion of Ernst & Young's review of the application of the performance conditions. Details of the Ordinary Warrants and Performance Warrants held by the Directors during 2007 are as follows:

(i) time vesting ordinary warrants

name of director	warrants at december 31, 2006	warrants at december 31, 2007	date of award	price paid	exercise price[1]	exercise date[2]	expiry date
Richard Brindle	7,625,217	7,625,217	16/12/05	nil	$5.00	16/12/05-16/12/08	16/12/15
Simon Burton	444,804	444,804	9/3/06	nil	$5.00	9/3/06-16/12/08	16/12/15
	114,378	114,378	21/9/06	nil	$5.00	21/9/06-16/12/08	16/12/15
	559,182	559,182					
Neil McConachie	635,435	453,152	16/12/05	nil	$5.00	16/12/05-16/12/08	16/12/15
	635,434	317,717	9/3/06	nil	$5.00	9/3/06-16/12/08	16/12/15
	1,270,869	770,869					

(ii) performance vesting warrants

name of director	warrants at december 31, 2006	warrants at december 31, 2007	date of award	price paid	exercise price[1]	exercise date[3]	expiry date
Richard Brindle	3,050,087	2,745,078	16/12/05	nil	$5.00	31/12/07-31/12/09	16/12/15
Simon Burton	266,884	240,196	9/3/06	nil	$5.00	31/12/07-31/12/09	16/12/15
	216,048	194,443	21/9/06	nil	$5.00	31/12/07-31/12/09	16/12/15
	482,932	434,639					
Neil McConachie	381,261	343,135	16/12/05	nil	$5.00	31/12/07-31/12/09	16/12/15
	381,261	343,135	9/3/06	nil	$5.00	31/12/07-31/12/09	16/12/15
	762,522	686,270					

(1) does not reflect the $1.10 reduction in the exercise price on the unvested warrants consequent upon the January 2008 dividend payment (see below).
(2) the ordinary warrants vest 25 per cent on issuance and 25 per cent on each of the first, second and third anniversary of the admission of the Company's shares to trading on AIM.
(3) the performance warrants vest 20 per cent on December 31, 2007, 40 per cent on December 31, 2008 and 40 per cent on December 31, 2009.

On December 10, 2007 the Company declared a strategic dividend of $1.10 per common share payable in £ sterling to shareholders of record on January 11, 2008. The declaration of the dividend triggered a contractual obligation, pursuant to the terms of all warrants, for the Company to pay an amount per warrant equivalent to the dividend for each vested warrant; and to adjust automatically the exercise price for each unvested warrant by an amount equivalent to the dividend. Consequently on January 25, 2008 the Company paid a dividend of £0.5622 per warrant on all of the vested ordinary warrants, reflecting the dividend paid to shareholders. The exercise price for the unvested ordinary and performance warrants has been adjusted downwards by $1.10 to $3.90 per warrant.

Payment to holders of vested performance warrants of an amount equivalent to the strategic dividend will be made in 2008 once the exact number of vested performance warrants is confirmed following completion of a review of the application of the performance conditions by Ernst & Young as required by the terms of the performance warrants.

On August 13, 2007 Neil McConachie exercised 500,000 Ordinary Warrants by way of a cashless exercise at a sale price of $7.10 (based on a market value five day average) resulting in the acquisition of 148,025 ordinary common shares by him. On August 17, 2007 Mr. McConachie sold the 148,025 common shares at a price of £3.32 each, realising £491,443.

restricted share scheme

Having consulted with external advisers and following shareholder approval obtained in the special general meeting of shareholders held on January 4, 2008, Lancashire has introduced a new restricted share scheme ("RSS") which will replace the LTIP for new awards. The purpose of awards under the RSS will be to motivate and retain Lancashire staff who are responsible for the attainment of the primary long-term performance goals of the Company and its subsidiaries. The executive Directors (and subject to the approval of the Board, the Chairman) will be eligible to receive share awards made by the remuneration committee under the RSS which will be subject to time and, normally, performance vesting conditions. The performance conditions will be set by the remuneration committee at the time of grant and will be chosen from among earnings per share, economic value added, net income, operating income, return on assets, return on capital, return on equity, return on investments, gross or net underwriting results, revenue, share price, stock price growth or total shareholder return. The RSS has not been submitted for approval by HM Revenue & Customs or any other tax authority.

pensions

Richard Brindle, Simon Burton and Neil McConachie receive pension contributions from the Company under a defined contribution pension plan the Company operates for its employees. Under this plan, and in line with market practice in Bermuda, the Company contributes 10 per cent of base salary up to a maximum of $20,000. In addition Richard Brindle receives contributions to a UK defined contribution pension plan in respect of his salary and employment with the Company's UK operations. Details of their 2007 and 2006 pension contributions are set out in the emoluments table at the end of this Directors' Remuneration Report.

payments to third parties

On January 1, 2006, two of the Company's founder shareholders, Capital Z Lancashire Partners, L.P. ("Capital Z") and Crestview Advisors, L.L.C., ("Crestview") entered into an agreement to provide monitoring services to the Company (the "Monitoring Fee Agreement"). Under the Monitoring Fee Agreement, Capital Z and Crestview receive an annual fee for the monitoring services, provided that Directors representing them hold a seat on the Company's Board. For monitoring services provided during 2007, Capital Z received $178,216 (2006 – $212,000) and Crestview received $39,017 (2006 – $69,500). Directors' fees paid to non-executive Directors representing Capital Z and Crestview are offset against the monitoring fees.

directors' emoluments

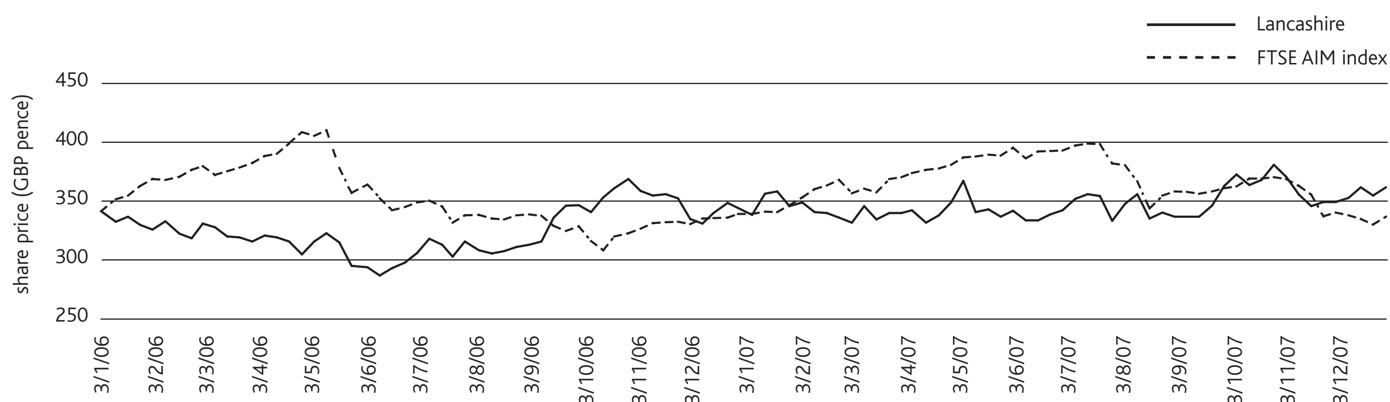
The Directors' emoluments for the two years ended December 31, 2007 are set out below:

All amounts in U.S. dollars

director		salary/fees for the company	salary/fee for other group companies	basic bonus	additional bonus	pension	other benefits	total
non-executive directors								
Martin Thomas	2007	231,675	100,330	–	–	–	–	332,005
	2006	26,715	31,043	–	–	–	–	57,758
Jens Juul	2007	17,500	–	–	–	–	–	17,500
Ralf Oelssner	2007	160,736	46,000	–	–	–	–	206,736
	2006	113,000	18,514	–	–	–	–	131,514
Robert Spass	2007	166,784	–	–	–	–	–	166,784
	2006	133,000	–	–	–	–	–	133,000
William Spiegel	2007	164,086	–	–	–	–	–	164,086
	2006	125,000	–	–	–	–	–	125,000
Barry Volpert	2007	133,483	–	–	–	–	–	133,483
	2006	103,000	–	–	–	–	–	103,000
executive directors								
Richard Brindle	2007	675,000	467,329(1)	4,545,754(1)	750,000	66,733(1)	208,608(1)	6,713,424(1)
	2006	675,000	242,117(1)	2,250,000(1)	–	48,296(1)	151,111(1)	3,366,524(1)
Simon Burton	2007	375,000	–	1,312,500	500,000	20,000	177,906	2,385,406
Neil McConachie	2007	330,000	–	990,000	250,000	20,000	185,676	1,775,676
	2006	275,000(2)	–	575,500(3)	–	20,000	264,812(4)	1,135,312

table notes:
(1) Some amounts paid in pounds sterling and converted at prevailing exchange rates.
(2) Full per annum salary is $300,000.
(3) Includes $50,500 special mid year bonus.
(4) Includes $75,000 in lieu of warrants.

total shareholder return



Approved by the Board of Directors and signed on behalf of the Board.

Greg Lunn, Compary Secretary
March 7, 2008

The Directors are responsible for preparing the Group's consolidated financial statements, in accordance with applicable law and regulation, which give a true and fair view of the state of affairs of the Group and the results of the Group for that period. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRS") and where IFRS is silent, as it is in respect of the measurement of insurance products, U.S. generally accepted accounting principles have been used. Further detail on the basis of preparation is described in the consolidated financial statements. In preparing the consolidated financial statements, the Directors are required to:

- select suitable accounting policies and apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRS;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the consolidated financial statements; and
- prepare the consolidated financial statements on the going concern basis unless it is inappropriate to presume that the Company and the Group will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and the Group, and to enable them to ensure that the consolidated financial statements comply with applicable law and regulation. They are also responsible for safeguarding the assets of the Group and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors have elected to include the corporate governance and remuneration information contained in this Annual Report, although the Company is not required to include these corporate governance and remuneration disclosures.

Legislation in Bermuda governing the preparation and dissemination of the consolidated financial statements may differ from legislation in other jurisdictions. In addition, the rights of shareholders under Bermuda law may differ from those for shareholders of companies incorporated in other jurisdictions.

to the shareholders
Lancashire Holdings Limited

We have audited the accompanying consolidated financial statements of Lancashire Holdings Limited and its subsidiaries (collectively the "Group"), which comprise the consolidated balance sheet as at December 31, 2007 and the consolidated income statement, consolidated statement of changes in shareholders' equity and consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

We read other information contained in the Annual Report and consider whether it is consistent with the audited consolidated financial statements. This other information comprises the Chairman's Statement, CEO's Statement, Review of results and outlook, Directors' Report, Corporate Governance Statement, Directors' Remuneration Report and Statement of Directors' Responsibilities. We consider the implications of our report if we become aware of any apparent misstatements or material inconsistencies with the consolidated financial statements. Our responsibilities do not extend to any other information.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

opinion

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Group as of December 31, 2007, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

/s/ Ernst & Young
March 7, 2008
#3 Reid Street
Hamilton, Bermuda

for the year ended december 31, 2007

	notes	2007 $m	2006 $m
gross premiums written	2	753.1	626.0
outwards reinsurance premiums	2	(86.3)	(78.5)
net premiums written		**666.8**	**547.5**
change in unearned premiums	2	(56.1)	(323.1)
change in unearned premiums on premium ceded	2	0.5	19.1
net premiums earned		**611.2**	**243.5**
net investment income	3	78.4	54.2
net other investment (losses) income	3, 20	(3.3)	1.8
net realised gains and impairments	3	9.1	0.8
net fair value gains on investments at fair value through income	3	0.4	–
share of profit of associate	12	6.2	3.2
net foreign exchange gains (losses)		2.3	(1.3)
total net revenue		**704.3**	**302.2**
insurance losses and loss adjustment expenses	2	150.0	39.1
insurance losses and loss adjustment expenses recoverable	2	(3.7)	–
net insurance losses		**146.3**	**39.1**
insurance acquisition expenses	2, 4, 25	95.6	40.0
insurance acquisition expenses ceded	2, 4	(19.1)	(5.1)
other operating expenses	5, 6, 7, 23	74.9	56.4
total expenses		**297.7**	**130.4**
results of operating activities		**406.6**	**171.8**
financing costs	19, 20	14.7	12.3
profit before tax		**391.9**	**159.5**
tax	8, 9	1.0	0.2
profit for the year attributable to equity shareholders		**390.9**	**159.3**
earnings per share			
basic	24	$2.01	$0.81
diluted	24	$1.91	$0.79

as at december 31, 2007

	notes	2007 $m	2006 $m
assets			
cash and cash equivalents	10	737.3	400.1
accrued interest receivable	14	9.8	7.5
investments			
– fixed income securities			
– available for sale	11	1,069.7	896.3
– at fair value through income	11	23.5	–
– equity securities			
– available for sale	11	71.6	70.3
– other investments	11, 20	4.4	11.5
reinsurance assets			
– unearned premium on premium ceded	13	19.6	19.1
– reinsurance recoveries	13	3.6	–
– other receivables	13	8.2	–
deferred acquisition costs	15	57.8	51.5
other receivables	14	3.8	6.3
inwards premium receivable from insureds and cedants	14	198.2	173.7
deferred tax asset	8, 9	2.0	0.8
investment in associate	12	22.9	23.2
property, plant and equipment	18	2.3	2.4
total assets		**2,234.7**	**1,662.7**
liabilities			
insurance contracts			
– losses and loss adjustment expenses	13	179.6	39.1
– unearned premiums	13	381.8	325.7
– other payables	13, 16	16.5	5.2
amounts payable to reinsurers	13, 16	5.7	0.8
deferred acquisition costs ceded	17	3.1	2.5
other payables	16	296.2	20.8
corporation tax payable	8	1.2	1.0
interest rate swap	20	2.2	0.9
accrued interest payable	19	0.5	0.5
long-term debt	19	132.3	128.6
total liabilities		**1,019.1**	**525.1**
shareholders' equity			
share capital	21, 22	91.1	97.9
share premium	21, 22	49.5	33.6
contributed surplus	27	754.8	849.7
fair value and other reserves	3, 11	20.7	8.7
dividends	21	(239.1)	–
retained earnings		538.6	147.7
total shareholders' equity attributable to equity shareholders		**1,215.6**	**1,137.6**
total liabilities and shareholders' equity		**2,234.7**	**1,662.7**

The consolidated financial statements were approved by the Board of Directors on March 7, 2008 and signed on its behalf by:

Martin Thomas

Neil McConachie

_consolidated statement of changes in shareholders' equity

for the year ended december 31, 2007

	notes	share capital $m	share premium $m	contributed surplus $m	fair value and other reserves $m	retained (deficit) earnings $m	total $m
balance as at december 31, 2005		**97.9**	**860.8**	**–**	**–**	**(11.6)**	**947.1**
profit for the year		–	–	–	–	159.3	159.3
change in investment unrealised gains (losses)	3, 11	–	–	–	8.7	–	8.7
total recognised income for the year		**–**	**–**	**–**	**8.7**	**159.3**	**168.0**
issue of share capital	21	–	0.3	(0.3)	–	–	–
transfer from share premium							
to contributed surplus	26	–	(850.0)	850.0	–	–	–
warrant issues – management and performance	6, 22	–	20.5	–	–	–	20.5
options issues – management	6, 22	–	2.0	–	–	–	2.0
balance as at december 31, 2006		**97.9**	**33.6**	**849.7**	**8.7**	**147.7**	**1,137.6**
profit for the year		–	–	–	–	390.9	390.9
change in investment unrealised gains (losses)	3, 11	–	–	–	12.4	–	12.4
corporation tax		–	–	–	(0.4)	–	(0.4)
total recognised income for the year		**–**	**–**	**–**	**12.0**	**390.9**	**402.9**
shares repurchased	21	(6.9)	–	(93.3)	–	–	(100.2)
dividends on common shares	16, 21	–	–	–	–	(200.5)	(200.5)
dividends on warrants		–	–	–	–	(38.6)	(38.6)
warrant issues – management and performance	6, 22	0.1	10.8	(1.6)	–	–	9.3
options issues – management	6, 22	–	5.1	–	–	–	5.1
balance as at december 31, 2007		**91.1**	**49.5**	**754.8**	**20.7**	**299.5**	**1,215.6**

for the year ended december 31, 2007

	notes	2007 $m	2006 $m
cash flows from operating activities			
profit before tax		391.9	159.5
tax paid		(2.4)	–
depreciation	7	1.4	0.6
interest expense		11.6	10.6
interest income		(78.5)	(52.8)
dividend income		(0.8)	(0.8)
amortisation of fixed income securities		(0.7)	(1.2)
employee benefits expense	5, 6	14.4	22.5
foreign exchange		(3.1)	1.9
share of profit of associate	12	(6.2)	(3.2)
net realised gains and impairments on investments	3	(9.1)	(0.8)
net realised and unrealised losses(gains) on other investments	3, 20	3.3	(1.8)
net fair value gains on investments at fair value through income		(0.4)	–
unrealised loss on interest rate swaps	20	1.3	0.9
reinsurance assets			
– unearned premium on premium ceded	13	(0.5)	(19.1)
– reinsurance recoveries	13	(3.5)	–
– other receivables	13	(8.2)	–
deferred acquisition costs	15	(6.3)	(51.0)
other receivables		2.4	(6.0)
inwards premium receivable from insureds and cedants		(23.8)	(171.4)
insurance contracts			
– losses and loss adjustment expenses	13	140.0	39.1
– unearned premiums	13	56.2	323.1
– other payables		11.3	3.6
amounts payable to reinsurers		4.9	2.4
deferred acquisition costs ceded	17	0.5	2.5
other payables		25.8	18.6
net cash flows from operating activities		**521.5**	**277.2**
cash flows used in investing activities			
interest received		76.2	47.0
dividends received		0.8	0.8
purchase of property, plant and equipment	18	(1.3)	(2.6)
investment in associate	12	–	(20.0)
dividends received from associate	12	6.5	–
purchase of fixed income securities		(2,143.3)	(2,086.1)
purchase of equity securities		(30.9)	(76.1)
proceeds on maturity and disposal of fixed income securities		1,960.4	1,185.6
proceeds on disposal of equity securities		36.9	20.9
net proceeds on (purchase of) other investments		5.1	(9.7)
net cash flows used in investing activities		**(89.6)**	**(940.2)**
cash flows used in financing activities			
interest paid		(11.6)	(10.5)
shares repurchased	21	(89.3)	–
net cash flows used in financing activities		**(100.9)**	**(10.5)**
net increase (decrease) in cash and cash equivalents		**331.0**	**(673.5)**
cash and cash equivalents at beginning of year		400.1	1,072.4
effect of exchange rate fluctuations on cash and cash equivalents		6.2	1.2
cash and cash equivalents at end of year	10	**737.3**	**400.1**

summary of significant accounting policies

The basis of preparation, consolidation principles and significant accounting policies adopted in the preparation of Lancashire Holdings Limited ("LHL") and its subsidiaries' (collectively "the Group") 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 International Financial Reporting Standards ("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, management determines appropriate measurement bases, to provide the most useful information to users of the consolidated financial statements, using their judgement and considering the accounting principles generally accepted in the United States ("U.S. GAAP").

All amounts, excluding share data or where otherwise stated, are in millions of United States ("U.S.") dollars.

The following new or amended standards have been adopted by the Group:

- IFRS 7, Financial Instruments Disclosure;
- IAS 1, Presentation of Financial Statements: Capital Disclosures.

There is no resulting change in accounting policies from the adoption of these standards. Enhanced investment risk and capital management disclosures have been provided in order to satisfy the requirements of these standards. IFRS 8, Operating Segments which has been issued, but is not yet effective, has not been early adopted by the Group. The Group continues to apply IAS 14, Segment Reporting. This standard is not expected to have a material impact on the results and disclosures reported in the consolidated financial statements.

All other new or amended IFRS and International Financial Reporting Interpretations Committee ("IFRIC") standards issued but not yet effective are similarly not expected to have a material impact on the results and disclosures of the Group.

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 management 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.

basis of consolidation

i. subsidiaries

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. The results of subsidiaries acquired are included in the consolidated financial statements from the date on which control is transferred to the Group. Intercompany balances, profits and transactions are eliminated.

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

ii. associates

Investments, in which the Group has significant influence over the operational and financial policies of the investee, are initially recognised at cost and thereafter accounted for using the equity method. Under this method, the Group records its proportionate share of income or loss from such investments in its results of operations 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 income statement. 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 fair value denominated in a foreign currency are translated at the exchange rate at the date the fair value was determined, with resulting exchange differences recorded in the fair value reserves in shareholders' equity.

insurance contracts

i. 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.

ii. premiums and acquisitions 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 premium.

Where contract terms require the reinstatement of coverage after an insured's or ceding company's estimated loss, the estimated mandatory reinstatement premiums are recorded as written premium when a specific loss event occurs. Reinstatement premiums are not recorded for losses included within the provision for losses incurred but not reported ("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 in income 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.

iii. 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 written which is estimated to be earned in future financial periods. Unearned reinsurance commissions are recognised as a liability using the same principles. Any amounts recoverable from reinsurers are estimated using the same methodology as the underlying losses.

The Group monitors the credit-worthiness of its reinsurers on an ongoing basis and assesses any reinsurance assets for impairment, with any impairment loss recognised in income in the period in which it is determined.

iv. 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 classes with high attachment points of coverage, including property catastrophe. Reserving for losses in such programs 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. Additional case reserves ("ACRs") are determined where the company's 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 case reserves reported by insureds or ceding companies, as well as a provision for losses which have occurred but which have not yet been reported to us by insureds or ceding companies. IBNR reserves are estimated by management using various actuarial methods as well as a combination of our own loss experience, historical insurance industry loss experience, our 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.

v. 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

i. cash and cash equivalents

Cash and cash equivalents are carried in the consolidated balance sheet at cost and includes 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 fair value due to its short-term nature and high liquidity.

ii. investments

The Group's fixed income and equity investments are quoted investments that are classified as available for sale or fair value through income 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 purchased since January 1, 2007 are designated as at fair value through income. Movements in estimated fair value relate primarily to the option component. Other investments relate primarily to the option component of securities with an embedded conversion option purchased prior to January 1, 2007. They are recorded at estimated fair value based on financial information received and other information available to management, including factors restricting the liquidity of the investments where appropriate.

Regular way purchases and sales of investments are recognised at estimated fair value less transaction costs on the trade date and are subsequently carried at estimated fair value. Estimated fair value of quoted investments is determined based on bid prices from recognised exchanges or broker-dealers. 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 the fair value reserve in shareholders' equity.

On derecognition of an investment, previously recorded unrealised gains and losses are removed from shareholders' equity and included in current period income. Changes in estimated fair value of investments classified as at fair value through income are recognised in current period income.

Amortisation and accretion of premiums and discounts on available for sale fixed income investments 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 fair value due to its short-term nature. Dividends on equity securities are recorded as revenue on the date the dividends become payable to the holders of record.

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 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 the fair value reserve in shareholders' equity and charged to current period income.

Impairment losses on equity securities are not subsequently reversed through income. Impairment losses on fixed income securities may be subsequently reversed through income.

iii. 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 fair value are recorded as derivative financial assets and those with a negative fair value are recorded as derivative financial liabilities. Embedded derivatives that are not closely related to their host contract are bifurcated and changes in estimated fair value are recorded through income.

Derivative and embedded derivative financial instruments include swap, option, forward and future contracts. 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, with changes in the estimated fair value of instruments that do not qualify for hedge accounting recognised in current period income. 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.

iv. 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 income statement. 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

i. equity compensation plans

The Group operates a management warrant plan and an option plan. The fair value of the equity instruments granted were estimated on the date of grant. The fair value is recognised as an expense pro-rata over the vesting period of the instrument. The total amount to be expensed is determined by reference to the fair value of the awards estimated at the grant date, excluding the impact of any non-market vesting conditions.

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

On exercise, the differences between the expense charged to the consolidated income statement and the actual cost to the Group is transferred to retained earnings. Where new shares are issued, the proceeds received are credited to share capital and share premium.

ii. 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 income statement in the period to which they relate.

founder and sponsor warrants

The Group issued warrants to certain founding shareholders, including LHL's Chief Executive Officer, and a sponsor on listing. The fair value of the equity instruments granted were estimated on the date of grant.

Warrants issued to founding shareholders were treated as a capital transaction and the associated fair value was credited to the share premium account. The fair value of warrants issued to the sponsor for assistance with incorporation and other start-up services was credited to the share premium account. The total amount to be credited was determined by reference to the fair value of the awards estimated at the grant date, excluding the impact of any non-market vesting conditions.

tax

Income tax expense 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 income statement 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.

risk disclosures: introduction
The Group is exposed to risks from several areas including insurance risk, market risk, liquidity risk, credit risk, operational risk and strategic risk. The primary risk to the Group is insurance risk.

The Group has a comprehensive Enterprise Risk Management ("ERM") program. ERM is co-ordinated by the Chief Risk Officer ("CRO") who reports to the Board of Directors. Risk Committees have been formed at the operating entity level. At the Group level, the role of the Risk Committee is carried out by the Board of Directors. The Board of Directors sets the overall risk profile and risk appetite for the Group. The CRO is responsible for translating this into business tolerance levels on specific identified risks and monitoring the adherence to these. Any breaches are reported to the Board of Directors.

The Risk Committees, with input from Executive and senior management, define tolerance levels over all categories of risk for the operating entities. This includes the level of capital the Group and operating entities are willing to expose to certain risks. Identification and monitoring of risks is the responsibility of individual risk owners. Risk owners periodically perform an exercise to identify the Group's most significant risks, in terms of both likelihood of occurrence and impact to the Group. The Risk Committees monitor progress in reducing these risks where deemed necessary or maintaining them at acceptable levels. The Committees meet formally at least quarterly to review, amongst other things, established tolerance levels, actual risk levels versus tolerances, emerging risks and material risk failures or losses. Risk reports are provided to the management team on at least a monthly basis to help the team monitor risk levels. The CRO provides a report on the activities of the operating entities' Risk Committees to the Board of Directors on a quarterly basis.

economic capital model
The Group has developed a sophisticated economic capital model ("BLAST"). BLAST provides management and the Board of Directors with information on risk and return that can assist with business decisions. BLAST is an integral part of the Group's ERM program. It is primarily a stochastic model that incorporates insurance risk, market risk, credit risk and other general risks, including operational risk. It requires the input of a large number of parameters and data. The inputs include historical data and projected future premium income, reinsurance programs, loss ratios, default rates, asset allocations and operational costs. All classes of business, including non-elemental classes, are within the capabilities of the model.

BLAST produces data in the form of a stochastic distribution. The distribution includes the mean outcome and the result at various return periods, including very remote events. This is analysed at both the micro and the macro level. At the micro level, BLAST produces risk/return information for individual risks and also within categories of risk, particularly insurance risk. This includes the calculation of present and projected financial outcomes for each insurance class, including non-elemental classes. At the macro level, BLAST 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. Diversification credit is calculated within categories, most notably within the insurance category, and across a range of risk categories. BLAST helps Executive management and the Board of Directors determine the level of capital required at both the Group and operating entity level 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.

There are several areas of uncertainty associated with achieving accurate results from BLAST. These include the following: incorrect assumptions on parameters; incorrect assumptions on frequency and severity of losses; external environmental factors, including trading conditions or major loss events; correlation factors between different types of risk; counter-party credit-worthiness; and changes in laws and regulations or interpretation.

The management of various types of risks is described in more detail below.

A. insurance risk
The Group underwrites contracts that transfer insurance risk. The Group underwrites worldwide short-tail insurance and reinsurance property risks, including risks exposed to natural catastrophes. The Group's exposure in connection with insurance contracts is, in the event of insured losses, whether premium 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, among other factors. The Group's underwriters assess likely losses using their experience and knowledge of past loss experience and current circumstances. This allows them to estimate the premium sufficient to meet likely losses and expenses. The Group considers insurance risk at an individual contract level, sector level, geographic level and at an aggregate portfolio level to ensure 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. The level of insurance risk tolerance per class per occurrence and in aggregate is set by the Risk Committees.

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

- A business plan is produced annually which includes expected premium and combined ratios by class. The plan is approved by the Board of Directors;
- The business plan is monitored and reviewed on an on-going basis;
- An economic capital model is used to measure occurrence risks, aggregate risks and correlations between classes;
- Each authorised class has a pre-determined normal maximum line structure;
- The Group has pre-determined 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 communicated broadly on a frequent and regular basis, helping identify where limits are being approached or exceeded;
- A daily underwriting meeting is held to peer review insurance proposals;
- Sophisticated pricing models are utilised in certain areas of the underwriting process, and are updated frequently;
- BLAST and other computer modeling tools are deployed to simulate catastrophes and resultant losses to the portfolio and the Group;
- Reinsurance is purchased to mitigate losses in peak areas of exposure.

The Group has established an internal audit function which is independent of the ERM and underwriting processes. The head of internal audit reports directly to the Audit Committee. The internal audit function is required to perform risk reviews on the underwriting function to ensure compliance with Group policies and required procedures.

The Group establishes targets for the maximum proportion of capital, including long-term debt, that can be lost in extreme events. Significant exposures include a very large wind event in the Gulf of Mexico or California quake event. Given seasonality, the risk of a very large California quake event is more relevant than U.S. hurricanes at December 31, 2007. The impact of an estimated 1 in 250 year California quake event at December 31, 2007 was 19% of capital (2006 – 25%), after collection of reinsurance and after payment and collection of reinstatement premiums. The impact of an estimated 1 in 100 year Gulf of Mexico wind event at December 31, 2007 was 24% of capital (2006 – 24%) after collection of reinsurance and after payment and collection of reinstatement premiums.

There can be no guarantee that the 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 event with an occurrence probability of greater than 1 in 250 years or a Gulf of Mexico wind event with an occurrence probability of greater than 1 in 100 years could cause a larger loss to capital, as could a different type of loss event with a different occurrence probability.

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

	2007		2006	
	$m	**%**	**$m**	**%**
property	309.3	41.1	254.5	40.6
energy	282.7	37.5	253.9	40.6
marine	76.9	10.2	53.1	8.5
aviation	84.2	11.2	64.5	10.3
total	**753.1**	**100.0**	**626.0**	**100.0**

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

	2007		2006	
	$m	%	$m	%
worldwide offshore	268.1	35.6	209.4	33.5
worldwide, including the U.S. and Canada[(1)]	205.0	27.2	168.2	26.9
U.S. and Canada	127.2	16.9	143.5	22.9
worldwide, excluding the U.S. and Canada[(2)]	49.8	6.6	32.6	5.2
europe	43.2	5.7	17.0	2.7
far east	17.3	2.3	19.9	3.2
middle east	13.5	1.8	17.1	2.7
rest of world	29.0	3.9	18.3	2.9
total	**753.1**	**100.0**	**626.0**	**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 United States of America and Canada.

Sections a to d below describe the risks in each of the four principal lines of business written by the Group.

a. property

Gross premiums written, for the year:

	2007 $m	2006 $m
property direct and facultative	122.8	111.4
property retrocession	88.5	112.8
terrorism	56.6	18.9
property cat excess of loss	19.3	0.6
property political risk	16.9	9.4
other property	5.2	1.4
total	**309.3**	**254.5**

Property direct and facultative is written for the full value of the risk, generally on an excess of loss basis. Cover is generally provided to large commercial enterprises with high value locations. Coverage is for non-elemental perils including fire and explosion and elemental (natural catastrophe) perils including flood, windstorm, earthquake and tornado. Coverage generally includes indemnification for both property damage and business interruption.

Property retrocession is written on an excess of loss basis through treaty arrangements. Programs are often written on a pillared basis, with separate geographic zonal limits for risks in the U.S. and Canada and for risks outside the U.S. and Canada. Property cat excess of loss may be written in a similar manner to property retrocession but is not written on a pillared basis. The Group is exposed to large catastrophic losses such as wind storm and earthquake loss from assuming property retrocession and property cat excess of loss risks. Exposure to such events is controlled and measured through setting limits on aggregate exposure per geographic zone and through loss modeling. The accuracy of the latter exposure analysis is limited by the quality of data and effectiveness of the modeling. It is possible that a catastrophic event exceeds the expected modeled event loss. The Group's appetite and exposure guidelines to large losses are set out on page 58. Reinsurance has also been purchased to mitigate gross losses in the U.S. and Canada.

Terrorism cover is provided for U.S. and worldwide property risks, but excludes nuclear, chemical and biological coverage in most territories.

Political risk cover is written on an individual case by case basis and coverage can vary significantly between policies.

b. energy

Gross premiums written, for the year:

	2007 $m	2006 $m
gulf of mexico offshore energy	157.5	171.8
worldwide offshore energy	72.7	42.3
onshore energy	25.3	13.5
construction energy	24.5	24.5
other energy	2.7	1.8
total	**282.7**	**253.9**

Energy risks are mostly written on a direct basis. Gulf of Mexico energy programs cover elemental and non-elemental risks. The largest exposure is from hurricanes in the Gulf of Mexico. Exposure to such events is controlled and measured through loss modeling but the accuracy of this exposure analysis is limited by the quality of data and effectiveness of the modeling. It is possible that a catastrophic event exceeds the expected event loss. The Group's appetite and exposure guidelines to large losses are set out on page 58. Policies have sub-limits on coverage for elemental losses. Non-elemental energy risks include fire and explosion. Reinsurance protection has been purchased to protect a portion of loss from elemental and non-elemental energy claims.

Worldwide offshore energy programs are generally for non-elemental risks. 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. Energy construction contracts generally cover all risks of platform and drilling units under construction.

c. marine

Gross premiums written, for the year:

	2007 $m	2006 $m
marine hull and total loss	29.4	26.1
marine builders risk	22.3	10.5
marine hull war	11.4	4.1
marine p&i clubs	9.4	6.4
marine excess of loss	4.4	4.3
other marine	–	1.7
total	**76.9**	**53.1**

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. Marine hull war is direct insurance of loss of vessels from war or terrorist attack. Marine P&I is mostly the reinsurance of The International Group of Protection and Indemnity Clubs. Marine excess of loss is generally written on a treaty basis. Marine cargo programs are not normally written. The largest expected exposure is from physical loss rather than from elemental loss events.

d. aviation

Gross premiums written, for the year:

	2007 $m	2006 $m
AV52	63.1	56.2
aviation reinsurance	10.7	1.1
other aviation	10.4	7.2
total	**84.2**	**64.5**

Aviation AV52 provides coverage for third party liability, excluding own passenger liability, resulting from acts of war or hijack of aircraft, excluding U.S. commercial airlines. Aviation reinsurance includes satellite cover.

Other aviation business includes aviation hull war risks.

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 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 and other factors. The Group Reinsurance Security Committee ("GRSC") has defined limits per market by rating and an aggregate exposure to a rating band. The Group considers reinsurers that are not rated or do not fall within the pre-defined rating categories on a case by case basis, and would usually require collateral to be posted to support obligations. The Group monitors the credit-worthiness of its reinsurers on an ongoing basis. The GRSC meets formally at least quarterly.

Reinsurance protection purchased typically includes a combination of excess of loss reinsurance, proportional reinsurance and occasionally includes industry loss warranty covers. The mix of reinsurance cover is dependent on the specific loss mitigation requirements, market conditions and available capacity. The primary focus of the Group's reinsurance program to date has been to reduce the Group's net exposure to a large natural catastrophe loss in the U.S. The Group also increasingly purchases cover to reduce net exposures to other large losses. 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 program would be retained by the Group. Some parts of the reinsurance program 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.

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. Claims arising from future events can be expected to require the establishment of substantial reserves from time to time.

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 the point estimate. 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 generally subject to a quarterly corroborative review by independent actuaries, using U.S. generally accepted actuarial principles.

The extent of reliance on management 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 majority of programs on a direct basis. Typically, over 80% of programs are expected to be written on an excess of loss basis. The Group does not currently write a significant amount of long-tail business.

a. 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 change.

Furthermore, as a broker market reinsurer, management must rely on loss information reported to brokers by 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.

b. short-tail versus long-tail
In general, claims relating to short-tail property risks, such as the majority of risks underwritten by the Group, are reported more promptly by third parties 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 primary insurers or with reinsurers.

c. excess of loss versus proportional
For excess of loss 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 treaties, generally an initial estimated loss and loss expense ratio (the ratio of losses and loss adjustment expenses incurred to premiums earned) is used, 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.

d. 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 claim frequency and high severity make 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.

e. 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. Because of the degree of reliance that is necessarily placed on insureds or ceding companies for claims reporting, the associated time lag, the low frequency/high severity nature of much of the business that the Group underwrites, and the varying reserving practices among ceding companies, reserve estimates are highly dependent on management judgement and therefore uncertain. During the loss settlement period, which may be years in duration, additional facts regarding individual claims and trends often will become known, and current laws and case law may change, with a 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 is greater uncertainty 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 allocation of claims to 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.

At December 31, 2007 management's estimates for IBNR represented 60.1% of total net loss reserves (2006 – 96.9%). 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 management 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. These include investment market factors and insurance market factors. The Group is also subject to interest rate risk on its debt and investments and currency risk to the extent foreign currency balances are not hedged. These risks and the management thereof are described below.

a. investments

Investment guidelines are established by the Investment Committee of the Board of Directors. 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 and maturity. Investment guidelines exist at the individual portfolio level and for the Group's consolidated portfolio. Compliance with guidelines is monitored on a monthly basis. Any adjustments to the investment guidelines are approved by the Investment Committee and the Board of Directors.

Within the Group guidelines is a sub-set of guidelines for the portion of funds required to meet potential insurance liabilities in an extreme event, plus other near term liquidity requirements, the "core" portfolio. The core portfolio is invested in fixed income securities and cash and cash equivalents. The core portfolio may contain assets significantly in excess of those required to meet insurance liabilities and other near term liquidity requirements. The sub-set of guidelines adds a further degree of requirements, including fewer allowable asset classes, higher credit quality, shorter duration and higher liquidity. The primary objective of this portion of assets is liquidity and capital preservation.

Assets in excess of those required to settle potential insurance liabilities in an extreme event, plus other near term liquidity requirements may be held in the core portfolio or in the "surplus" portfolio. The surplus portfolio, is invested in fixed income securities, cash and cash equivalents and a modest amount of equity securities. These assets are not matched to specific insurance liabilities. In general, the duration is slightly longer, while maintaining focus on high quality assets. The Group also holds a modest amount of convertible debt securities. These instruments are either bifurcated into their component parts with the embedded option fair valued through the income statement or designated as at fair value through income with changes in estimated fair value recognised directly in income. Currently, the Group does not hold any alternative investments such as hedge funds.

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.

The fixed income portfolios are managed by two external investment managers with identical mandates. The equity portfolio is managed by one investment manager. The equity portfolio is invested predominantly in U.S. securities in a diversified range of sectors, and includes convertible debt. The performance of the managers is monitored on an on-going basis.

Asset allocation by manager is as follows:

as at december 31, 2007	$m	$m	$m	$m
	goldman sachs	blackrock	equity manager	total
fixed income securities	629.9	421.8	41.5	1,093.2
equity securities	0.5	–	71.1	71.6
other investments	–	–	4.4	4.4
cash	79.7	267.9	7.1	354.7
total	**710.1**	**689.7**	**124.1**	**1,523.9**
	%	%	%	%
fixed income securities	41.3	27.7	2.7	71.7
equity securities	–	–	4.7	4.7
other investments	–	–	0.3	0.3
cash	5.2	17.6	0.5	23.3
total	**46.5**	**45.3**	**8.2**	**100.0**

as at december 31, 2006	$m	$m	$m	$m
	goldman sachs	blackrock	equity manager	total
fixed income securities	430.8	434.8	30.7	896.3
equity securities	5.7	–	64.6	70.3
other investments	–	–	11.5	11.5
cash	110.1	108.3	6.6	225.0
total	**546.6**	**543.1**	**113.4**	**1,203.1**
	%	%	%	%
fixed income securities	35.8	36.1	2.6	74.5
equity securities	0.4	–	5.4	5.8
other investments	–	–	1.0	1.0
cash	9.2	9.0	0.5	18.7
total	**45.4**	**45.1**	**9.5**	**100.0**

The Group's expected gross insurance liabilities, in an extreme event plus near term liability requirements, are $652.7 million (2006 – $449.3 million). Recoveries from reinsurance programs are not factored into the calculation.

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

	december 31, 2007			december 31, 2006		
	$m	$m	$m	$m	$m	$m
	core	**surplus**	**total**	**core**	**surplus**	**total**
available for sale						
– short-term investments	–	0.7	0.7	2.1	4.8	6.9
– U.S. treasuries	207.9	46.5	254.4	15.0	15.8	30.8
– U.S. government agency debt	195.7	13.6	209.3	102.1	48.3	150.4
– asset backed securities	–	–	–	80.8	40.3	121.1
– U.S. government agency mortgage backed securities	153.5	87.6	241.1	77.6	137.0	214.6
– non-agency mortgage backed securities	6.0	1.0	7.0	63.0	89.5	152.5
– corporate bonds	309.8	33.5	343.3	125.4	65.7	191.1
– convertible debt securities	–	13.9	13.9	–	28.9	28.9
available for sale	**872.9**	**196.8**	**1,069.7**	**466.0**	**430.3**	**896.3**
at fair value through income						
– convertible debt securities	–	23.5	23.5	–	–	–
at fair value through income	**–**	**23.5**	**23.5**	**–**	**–**	**–**
total fixed income securities	**872.9**	**220.3**	**1,093.2**	**466.0**	**430.3**	**896.3**

	%	%	%	%	%	%
available for sale						
– short-term investments	–	0.1	0.1	0.2	0.5	0.7
– U.S. treasuries	19.0	4.3	23.3	1.7	1.8	3.5
– U.S. government agency debt	17.9	1.2	19.1	11.4	5.4	16.8
– asset backed securities	–	–	–	9.0	4.5	13.5
– U.S. government agency mortgage backed securities	14.0	8.0	22.0	8.7	15.3	24.0
– non-agency mortgage backed securities	0.6	0.1	0.7	7.0	10.0	17.0
– corporate bonds	28.3	3.1	31.4	14.0	7.3	21.3
– convertible debt securities	–	1.3	1.3	–	3.2	3.2
available for sale	**79.8**	**18.1**	**97.9**	**52.0**	**48.0**	**100.0**
at fair value through income						
– convertible debt securities	–	2.1	2.1	–	–	–
at fair value through income	**–**	**2.1**	**2.1**	**–**	**–**	**–**
total fixed income securities	**79.8**	**20.2**	**100.0**	**52.0**	**48.0**	**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, economic environment and outlook, and exchange rates.

The impact on net unrealised gains and losses of a 10% fall in the value of the Group's equity portfolio at December 31, 2007 would be $7.2 million (2006 – $7.0 million). Valuation risk in the equity portfolio is mitigated by diversifying the portfolio across sectors.

The majority of the Group's investments comprise fixed income securities. The 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 investments would tend to rise and vice versa.

The sensitivity of the price of fixed income securities is indicated by its duration(1). The greater a security's duration, the greater its percentage price volatility. The sensitivity of the Group's fixed income portfolio to interest rate movements is as follows:

	december 31, 2007		**december 31, 2006**	
immediate shift in yield (basis points)	**%**	**$m**	**%**	**$m**
100	-2.2	(24.4)	-2.3	(21.0)
75	-1.7	(18.3)	-1.7	(15.8)
50	-1.1	(12.2)	-1.2	(10.5)
25	-0.6	(6.1)	-0.6	(5.3)
-25	0.6	6.1	0.6	5.3
-50	1.1	12.2	1.2	10.5
-75	1.7	18.3	1.7	15.8
-100	2.2	24.4	2.3	21.0

(1) Duration is the weighted average maturity of a security's cash flows, where the present values of the cash flows serve as the weights. The effect of convexity on the portfolio's response to changes in interest rates is not significant and has not been factored into the data above.

The Board of Directors limits interest rate risk on the investment portfolio by establishing and monitoring duration ranges within investment guidelines. The target duration for the core portfolio is between one and three years and for the surplus portfolio is between one and five years. The duration of the fixed income portfolios at December 31, 2007 was 1.9 years for the core portfolio (2006 – 1.5) and 3.4 years for the surplus portfolio (2006 – 3.2).

In addition to duration management, the Group uses Value at Risk ("VaR") to measure potential losses in the estimated fair values of its cash and invested assets. Management measures VaR on a monthly basis to understand and monitor risk.

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 measure that is produced is a ninety day VaR at a 99% confidence level. Management also monitors the 95% confidence interval. The ninety day VaR, at a 99% confidence interval, measures the minimum amount by which the assets should be expected to lose in a ninety day time horizon, under normal conditions, 1% of the time. The current VaR tolerance is 3.0% of shareholders' equity, using the ninety day VaR at a 99th percentile confidence level. The Group's VaR calculations are as follows:

	december 31, 2007		**december 31, 2006**	
	%	**$m**	**%**	**$m**
99th per cent confidence level	2.2	26.9	1.6	18.6
95th per cent confidence level	1.6	19.1	1.2	13.2

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

b. insurance

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

- The advent of a soft insurance market, which may result in a stabilisation or decline in premium ratings and levels 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.

The most important measure to mitigate insurance risk is to maintain strict underwriting standards. Examples of how the Group reacts to insurance risk include the following:

- Review and amend underwriting plans and budgets as necessary;
- Reduce exposure to market sectors where conditions have reached unattractive levels;
- Purchase appropriate reinsurance cover to mitigate exposure;
- Closely monitor changes in rates, and terms and conditions;
- Regular review of output from the Group's economic capital model, BLAST, to judge up-to-date profitability of classes and sectors.

c. debt

The Group has issued long-term debt as described in note 19. The loan notes bear interest at a floating rate that is re-set on a quarterly basis plus a fixed margin of 3.7%. The Group is subject to interest rate risk on the coupon payments of the long-term debt. The Group has mitigated the interest rate risk by entering into swap contracts as follows:

	maturity date	**prepayment date**	**interest hedged**
subordinated loan notes €24 million	june 15, 2035	march 15, 2011	50%
subordinated loan notes $97 million	december 15, 2035	december 15, 2011	50%

The notional amounts of $50 million and €12 million respectively are due on March 15, 2011.

In certain circumstances the subordinated notes can be prepaid from December 16, 2005, with a sliding scale redemption price penalty which reduces to zero by December 15, 2011. See note 19 for further details.

The current Euribor interest rate on 50% of the Euro subordinated loan notes has been fixed at 4.95%. The current LIBOR interest rate on 50% of the U.S. dollar subordinated loan notes has been fixed at 4.99%. The Group retains exposure to interest risk on the remaining portion of the notes.

d. currency risk

The Group currently underwrites out of 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 has hedged non U.S. dollar liabilities with non U.S. dollar assets. The Group's main foreign currency exposure relates to its insurance obligations, cash holdings, premiums receivable and the €24 million subordinated notes long-term debt liability.

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

assets	$m	$m	$m	$m	$m
	U.S. $	**sterling**	**euro**	**other**	**total**
cash and cash equivalents	401.3	266.3	66.5	3.2	737.3
accrued interest receivable	9.8	–	–	–	9.8
investments	1,169.2	–	–	–	1,169.2
unearned premium on premium ceded	19.6	–	–	–	19.6
reinsurance recoveries	3.6	–	–	–	3.6
reinsurance – other receivables	8.2	–	–	–	8.2
deferred acquisition costs	48.1	1.7	4.3	3.7	57.8
other receivables	2.6	1.2	–	–	3.8
inwards premium receivable from insureds	159.1	11.4	18.3	9.4	198.2
deferred tax asset	–	2.0	–	–	2.0
investment in associate	22.9	–	–	–	22.9
property, plant and equipment	0.6	1.6	–	0.1	2.3
total assets as at december 31, 2007	**1,845.0**	**284.2**	**89.1**	**16.4**	**2,234.7**

liabilities	$m	$m	$m	$m	$m
	U.S. $	**sterling**	**euro**	**other**	**total**
losses and loss adjustment expenses	156.6	1.8	16.1	5.1	179.6
unearned premiums	323.9	15.7	23.9	18.4	381.9
insurance contracts – other payables	14.3	0.5	1.0	0.7	16.5
amounts payable to reinsurers	5.7	–	–	–	5.7
deferred acquisition costs ceded	3.0	–	–	–	3.0
other payables	284.3	11.7	0.2	–	296.2
corporation tax payable	–	1.2	–	–	1.2
interest rate swap	2.5	–	(0.3)	–	2.2
accrued interest payable	0.4	–	0.1	–	0.5
long-term debt	97.0	–	35.3	–	132.3
total liabilities as at december 31, 2007	**887.7**	**30.9**	**76.3**	**24.2**	**1,019.1**

assets	$m	$m	$m	$m	$m
	U.S. $	**sterling**	**euro**	**other**	**total**
cash and cash equivalents	359.0	1.3	37.1	2.7	400.1
accrued interest receivable	7.5	–	–	–	7.5
investments	978.1	–	–	–	978.1
unearned premium on premium ceded	19.1	–	–	–	19.1
deferred acquisition costs	48.5	0.2	1.6	1.2	51.5
other receivables	5.1	1.2	–	–	6.3
inwards premium receivable from insureds	161.6	0.7	5.6	5.8	173.7
deferred tax asset	–	0.8	–	–	0.8
investment in associate	23.2	–	–	–	23.2
property, plant and equipment	1.4	1.0	–	–	2.4
total assets as at december 31, 2006	**1,603.5**	**5.2**	**44.3**	**9.7**	**1,662.7**

liabilities	$m	$m	$m	$m	$m
	U.S. $	sterling	euro	other	total
losses and loss adjustment expenses	38.0	0.2	0.9	–	39.1
unearned premiums	304.9	2.0	10.4	8.4	325.7
insurance contracts – other payables	5.2	–	–	–	5.2
amounts payable to reinsurers	0.8	–	–	–	0.8
deferred acquisition costs ceded	2.5	–	–	–	2.5
other payables	19.8	1.0	–	–	20.8
corporation tax payable	–	1.0	–	–	1.0
interest rate swap	1.0	–	(0.1)	–	0.9
accrued interest payable	0.4	–	0.1	–	0.5
long-term debt	97.0	–	31.6	–	128.6
total liabilities as at december 31, 2006	**469.6**	**4.2**	**42.9**	**8.4**	**525.1**

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 $28.2 million (2006 – $21.7 million).

C. liquidity risk

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

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

	december 31, 2007			december 31, 2006		
fixed income securities	$m	$m	$m	$m	$m	$m
	core	surplus	total	core	surplus	total
less than one year	45.8	2.0	47.8	21.3	–	21.3
between one and two years	347.6	29.9	377.5	114.8	27.1	141.9
between two and three years	166.4	5.8	172.2	61.7	11.4	73.1
between three and four years	56.6	15.4	72.0	28.0	27.6	55.6
between four and five years	75.3	14.7	90.0	3.3	30.5	33.8
over five years	21.7	63.9	85.6	15.6	66.8	82.4
asset-backed and mortgage-backed securities	159.5	88.6	248.1	221.3	266.9	488.2
total	**872.9**	**220.3**	**1,093.2**	**466.0**	**430.3**	**896.3**

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

as at december 31, 2007	$m	$m	$m	$m	$m
		years until liability becomes due			
	less than one	one to three	three to five	over five	total
losses and loss adjustment expenses	64.4	71.8	24.2	19.2	179.6
insurance contracts – other payables	15.3	0.8	0.4	–	16.5
amounts payable to reinsurers	5.7	–	–	–	5.7
other payables	296.2	–	–	–	296.2
corporation tax payable	1.2	–	–	–	1.2
accrued interest payable	0.5	–	–	–	0.5
long-term debt	–	–	–	132.3	132.3
total	**383.3**	**72.6**	**24.6**	**151.5**	**632.0**

as at december 31, 2006	$m	$m	$m	$m	$m
	years until liability becomes due				
	less than one	one to three	three to five	over five	total
losses and loss adjustment expenses	17.0	13.6	4.6	3.9	39.1
insurance contracts – other payables	4.7	0.5	–	–	5.2
amounts payable to reinsurers	0.8	–	–	–	0.8
other payables	20.8	–	–	–	20.8
corporation tax payable	1.0	–	–	–	1.0
accrued interest payable	0.5	–	–	–	0.5
long-term debt	–	–	–	128.6	128.6
total	**44.8**	**14.1**	**4.6**	**132.5**	**196.0**

Actual maturities of the above may differ from contractual maturities because certain borrowers have the right to call or pre-pay certain obligations with or without call or prepayment penalties. The prepayment options for the Group's long-term debt are discussed in note 19.

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 sub-set of guidelines ensures funds are readily available to meet potential insurance liabilities in an extreme event plus other near term liquidity requirements.

In addition, the Investment Committee of the Board of Directors has established asset allocation and maturity parameters within the investment guidelines such that the majority of the Group's investments are in high quality assets which could be converted into cash promptly and at minimal expense. Management monitors market changes and outlooks and re-allocates assets as deemed necessary.

D. credit risk

Credit risk is the risk that a counter-party 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 premium 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 BBB-/Baa3 may comprise no more than 5% of shareholders' equity, with the exception of U.S. government and agency securities. In addition, no one issuer 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.

The Group is exposed to credit risk in the event of non-performance of counter-parties to derivative contracts. These counter-parties are high credit quality banks and therefore exposure is expected to be negligible. Further, these instruments are typically net settled and are short-term in nature.

Credit risk on inwards premium receivable from insureds and cedants is managed by conducting business with reputable broking organisations with established relationships and by rigorous cash collection procedures. Credit risk from reinsurance recoverables is primarily managed by review and approval of reinsurer security by the Group's Reinsurance Security Committee as discussed on page 61.

The table below presents an analysis of the Group's major exposures to counter-party credit risk, based on their Standard & Poor's or equivalent 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.

december 31, 2007	$m	$m	$m	$m
	equities and derivative assets	cash and fixed income	premium and other receivables	outstanding claims and IBNR recoverable
AAA	–	1,478.8	–	–
AA+, AA, AA–	–	119.2	–	–
A+, A, A–	–	161.2	8.2	3.6
BBB+, BBB, BBB–	–	56.3	–	–
other	76.0	15.0	202.0	–
total	**76.0**	**1,830.5**	**210.2**	**3.6**

december 31, 2006	$m	$m	$m	$m
	equities and derivative assets	cash and fixed income	premium and other receivables	outstanding claims and IBNR recoverable
AAA	–	1,018.8	–	–
AA+, AA, AA–	–	43.6	–	–
A+, A, A–	–	173.8	–	–
BBB+, BBB, BBB–	–	51.9	–	–
other	81.8	8.3	180.0	–
total	**81.8**	**1,296.4**	**180.0**	**–**

The counter-party to the Group's interest rate swap is AA rated.

The following table shows inwards premium receivables that are past due but not impaired:

	december 31, 2007 $m	december 31, 2006 $m
less than 90 days past due	21.6	20.2
between 91 & 180 days past due	0.7	3.7
over 180 days past due	0.8	0.5
total	**23.1**	**24.4**

Provisions of $0.3 million (2006 – $nil) have been made for impaired or irrecoverable balances. 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, people or systems including the risk of fraud, safety, damage to physical assets, business disruption, system failure and transaction processing failure.

The Group has a robust self governance framework. Policies and procedures are documented and are reviewed and updated at least quarterly. The Group's internal audit function assesses the key risk areas on an annual basis and performs reviews over these areas to ensure controls are in place and are operating effectively.

Information technology risk tolerances have been defined and system performance is monitored continuously. The Group's disaster recovery plan is re-assessed and updated on a regular basis.

F. strategic risk

Strategic risk encompasses the risk that poor business planning and vision may produce a lower return on capital and value creation. Further, this could lead to risk tolerances being unclear or inappropriate. Management address this risk by a continual rigorous assessment of business goals. BLAST is increasingly an integral part of the review of profitability and capital utilisation. The Group's strategy is reaffirmed with the Board of Directors on a quarterly basis. Market or economic events may lead to a need to re-assess strategy more frequently.

a. capital risk management

The total capital of the Group as at December 31, 2007 is determined as $1,347.9 million (2006 – $1,266.2 million) comprising $1,215.6 million of shareholders' equity (2006 – $1,137.6 million) and $132.3 million of long-term debt (2006 – $128.6 million). The Group's capital requirements vary with the insurance cycle.

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

(i) maintaining sufficient capital for underwriting opportunities and to meet obligations to policyholders;
(ii) maximising the return to shareholders with pre-determined risk tolerances; and
(iii) maintaining adequate financial strength ratings and meeting regulatory requirements.

Capital is therefore raised or returned as appropriate. Capital raising can include debt or equity and returns of capital may be made through dividends, share buy backs or redemption of debt. 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, and the capital requirements of the combination of a wide range of other risk categories. Management increasingly uses these approaches in decision making. The operating companies 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 companies.

b. value creation and risk adjusted return

Management's aim is to provide the Group's shareholders with a risk adjusted return on equity of 13% in excess of a risk free rate over the insurance cycle. The return is measured by management in terms of the internal rate of return ("IRR") of the increase in fully converted book value per share ("FCBVS") in the period plus dividends accrued. This aim is a long-term goal, acknowledging that management expect both higher and lower results in the shorter term. The cyclicality and volatility of the insurance market drives this pattern and the management team 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. Within the insurance industry, downturns in the profitability of the cycle present the biggest challenge. The BLAST model assists the Group's underwriting team in determining the mix of the portfolio. There is a risk that incorrect assumptions in BLAST will lead the Group to assuming a risk that does not provide an appropriate return. Parameter risks are discussed further on page 57. The management team reduces this risk by continual re-assessment of the assumptions made.

1. general information

The Group is a provider of global property insurance and reinsurance products. LHL was incorporated under the laws of Bermuda on October 12, 2005. LHL is listed on AIM, a subsidiary market of the London Stock Exchange. A secondary listing on the Bermuda Stock Exchange ("BSX") was approved on May 21, 2007. The registered office of LHL is Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda. LHL has five subsidiaries, all wholly owned: Lancashire Insurance Company Limited ("LICL"), Lancashire Insurance Holdings (UK) Limited ("LIHUKL"), Lancashire Insurance Marketing Services Limited ("LIMSL"), Lancashire Insurance Services Limited ("LISL") and Lancashire Marketing Services (Middle East) Limited ("LMSMEL"). LIHUKL is a holding company for a wholly owned operating subsidiary, Lancashire Insurance Company (UK) Limited ("LICUKL").

The subsidiaries were incorporated and licensed as insurance companies or intermediaries as follows:

	LICL	LICUKL	LIMSL	LISL	LMSMEL
date of incorporation	october 28, 2005	march 17, 2006	october 7, 2005	march 17, 2006	march 11, 2007
licensing body	BMA[1]	FSA[2]	FSA	none	DFSA[3]

(1) Bermuda Monetary Authority ("BMA")
(2) United Kingdom, Financial Services Authority ("FSA")
(3) Dubai Financial Services Authority ("DFSA")

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. Management has therefore deemed these classes to be its business and primary segments for the purposes of segmental reporting. Further sub-classes of business are underwritten within each primary segment.

revenue and expense by business segment

gross premiums written	$m	$m	$m	$m	2007 $m
	property	**energy**	**marine**	**aviation**	**total**
analysed by geographical segment:					
worldwide offshore	0.7	213.1	54.3	–	268.1
worldwide, including the U.S. and Canada[1]	75.1	34.2	12.5	83.2	205.0
U.S. and Canada	114.2	12.8	0.2	–	127.2
worldwide, excluding the U.S. and Canada[2]	43.9	4.1	1.5	0.3	49.8
europe	35.4	2.8	4.4	0.6	43.2
far east	10.4	2.7	4.2	–	17.3
middle east	6.2	8.2	(1.0)	0.1	13.5
rest of world	23.4	4.8	0.8	–	29.0
total	**309.3**	**282.7**	**76.9**	**84.2**	**753.1**

2. segmental reporting continued

	$m	$m	$m	$m	2007 $m
	property	**energy**	**marine**	**aviation**	**total**
outwards reinsurance premiums	(23.0)	(63.3)	–	–	(86.3)
change in unearned premiums	(23.8)	(16.4)	(7.9)	(8.0)	(56.1)
change in unearned premiums ceded	(0.1)	0.6	–	–	0.5
net premiums earned	**262.4**	**203.6**	**69.0**	**76.2**	**611.2**
insurance losses and loss adjustment expenses	(36.8)	(71.3)	(38.0)	(3.9)	(150.0)
insurance losses recoverable	–	3.7	–	–	3.7
insurance acquisition expenses	(32.3)	(37.4)	(14.9)	(11.0)	(95.6)
insurance acquisition expenses ceded	1.0	18.1	–	–	19.1
net underwriting profit	**194.3**	**116.7**	**16.1**	**61.3**	**388.4**
net investment income					78.4
net other investment losses					(3.3)
net realised gains and impairments					9.1
net fair value gains on investments at fair value through income					0.4
share of profit of associate					6.2
net foreign exchange gains					2.3
operating expenses unrelated to underwriting					(60.5)
equity based compensation					(14.4)
financing costs					(14.7)
profit before tax					**391.9**
tax					(1.0)
profit for the year attributable to equity shareholders					**390.9**

	property	**energy**	**marine**	**aviation**	**total**
loss ratio	14.0%	33.2%	55.1%	5.1%	23.9%
acquisition cost ratio	11.9%	9.5%	21.6%	14.4%	12.5%
expense ratio	–	–	–	–	9.9%
combined ratio	**25.9%**	**42.7%**	**76.7%**	**19.5%**	**46.3%**

2. segmental reporting continued

gross premiums written	$m	$m	$m	$m	2006 $m
	property	energy	marine	aviation	total
analysed by geographical segment:					
worldwide offshore	–	175.5	33.9	–	209.4
worldwide, including the U.S. and Canada[1]	71.5	26.2	7.4	63.1	168.2
U.S. and Canada	111.7	31.4	0.4	–	143.5
worldwide, excluding the U.S. and Canada[2]	31.4	0.5	0.6	0.1	32.6
far east	10.6	2.6	6.7	–	19.9
middle east	6.7	9.0	1.3	0.1	17.1
europe	12.3	1.9	2.8	–	17.0
rest of world	10.3	6.8	–	1.2	18.3
total	**254.5**	**253.9**	**53.1**	**64.5**	**626.0**
outwards reinsurance premiums	(39.8)	(38.7)	–	–	(78.5)
change in unearned premiums	(123.5)	(119.4)	(28.8)	(51.4)	(323.1)
change in unearned premiums ceded	7.3	11.8	–	–	19.1
net premiums earned	**98.5**	**107.6**	**24.3**	**13.1**	**243.5**
insurance losses and loss adjustment expenses	(13.2)	(17.2)	(8.7)	–	(39.1)
insurance acquisition expenses	(12.7)	(20.1)	(4.6)	(2.6)	(40.0)
insurance acquisition expenses ceded	1.5	3.6	–	–	5.1
net underwriting profit	**74.1**	**73.9**	**11.0**	**10.5**	**169.5**
net investment income					54.2
net other investment income					1.8
net realised gains and impairments					0.8
share of profit of associate					3.2
net foreign exchange losses					(1.3)
operating expenses unrelated to underwriting					(33.9)
equity based compensation					(22.5)
financing costs					(12.3)
profit before tax					**159.5**
tax					(0.2)
profit for the year attributable to equity shareholders					**159.3**

	property	energy	marine	aviation	total
loss ratio	13.4%	16.0%	35.8%	–	16.1%
acquisition cost ratio	11.4%	15.3%	18.9%	19.8%	14.3%
expense ratio	–	–	–	–	13.9%
combined ratio	**24.8%**	**31.3%**	**54.7%**	**19.8%**	**44.3%**

2. segmental reporting continued

assets and liabilities by business segment

					december 31, 2007
assets	**$m**	**$m**	**$m**	**$m**	**$m**
	property	**energy**	**marine**	**aviation**	**total**
attributable to business segments	100.2	88.2	37.0	64.8	290.2
other assets					1,944.5
total assets					**2,234.7**

liabilities	**$m**	**$m**	**$m**	**$m**	**$m**
	property	**energy**	**marine**	**aviation**	**total**
attributable to business segments	200.2	240.0	81.7	64.8	586.7
other liabilities					432.4
total liabilities					**1,019.1**
total net assets					**1,215.6**

					december 31, 2006
assets	**$m**	**$m**	**$m**	**$m**	**$m**
	property	**energy**	**marine**	**aviation**	**total**
attributable to business segments	82.2	82.7	29.3	57.0	251.2
other assets					1,411.5
total assets					**1,662.7**

liabilities	**$m**	**$m**	**$m**	**$m**	**$m**
	property	**energy**	**marine**	**aviation**	**total**
attributable to business segments	128.8	154.6	38.2	51.7	373.3
other liabilities					151.8
total liabilities					**525.1**
total net assets					**1,137.6**

(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 United States of America and Canada.

The Group's net assets are located primarily in Bermuda. Less than 10% of total net assets were attributable to the UK operations for the years ended December 31, 2007 and 2006.

3. investment return

The total investment return for the Group is as follows:

	2007 $m	2006 $m
investment income		
– interest on fixed income securities	60.0	33.3
– net amortisation of (premium) discount	2.6	3.2
– interest income on cash and cash equivalents	18.6	19.2
– dividends from equity securities	0.8	0.8
– investment management and custodian fees	(3.6)	(2.3)
net investment income	**78.4**	**54.2**
net realised and unrealised (losses) gains on other investments	**(3.3)**	**1.8**
net realised gains (losses) and impairments		
– fixed income securities	5.0	(2.4)
– equity securities	4.1	3.2
net realised gains (losses) and impairments	**9.1**	**0.8**
net change in unrealised gains recognised in shareholders' equity		
– fixed income securities	9.2	2.6
– equity securities	3.2	6.1
net change in unrealised gains recognised in shareholders' equity	**12.4**	**8.7**
total investment return on available for sale investments	**96.6**	**65.5**
net fair value gains on investments at fair value through income	**0.4**	**–**
total investment return	**97.0**	**65.5**

Net realised gains on equity and fixed income securities includes an impairment loss of $1.3 million (2006 – $0.4 million).

Movements within unrealised gains and losses within shareholders' equity are as follows:

	2007 $m	2006 $m
fixed income securities		
– net unrealised (gains) losses released to income statement	(2.7)	2.4
– net unrealised gains credited to equity	11.5	0.2
– net unrealised losses released for impairments to income statement	0.4	–
equity securities		
– net unrealised gains released to income statement	(4.4)	(3.6)
– net unrealised gains credited to equity	7.1	9.3
– net unrealised losses released for impairments to income statement	0.5	0.4
net unrealised gains recognised in shareholders' equity	**12.4**	**8.7**

4. net insurance acquisition expenses

	2007 $m	2006 $m
insurance acquisition expenses	101.9	91.0
changes in deferred insurance acquisition expenses	(6.3)	(51.0)
insurance acquisition expenses ceded	(19.7)	(7.6)
changes in deferred insurance acquisition expenses ceded	0.6	2.5
total	**76.5**	**34.9**

5. other operating expenses

	2007 $m	2006 $m
operating expenses unrelated to underwriting	60.5	33.9
equity based compensation	14.4	22.5
total	**74.9**	**56.4**

6. employee benefits

	2007 $m	2006 $m
wages and salaries	12.8	5.4
pension costs	0.9	0.6
bonus and other benefits	23.1	7.5
equity based compensation	14.4	22.5
total	**51.2**	**36.0**

equity based compensation

There are two forms of equity based compensation: warrants and a long-term incentive plan.

On admission to AIM, warrants to purchase common shares were issued for immediate allocation to certain members of management or reserved for later allocation to employees of the Group. There are two forms of warrant that were issued for this purpose: management team ordinary warrants and management team performance warrants.

All warrants issued to management expire on December 16, 2015 and are exercisable at an initial price per share of $5.00, equal to the price per share paid by investors in the initial public offering, adjusted for dividend payments made prior to vesting. Settlement is at the discretion of the Group and may be in cash or shares.

Under the terms of the management warrants, warrant holders are entitled to receive a payment equivalent to any dividend or distribution that LHL makes to holders of common shares pro-rata, based on the number of warrant shares for which the warrant is then exercisable and have vested in accordance with any time, performance or other criteria, without adjusting the exercise price in respect thereof. In addition, the exercise price of each warrant share that has not become exercisable, and has not vested in accordance with any time, performance, or other criteria at the time of such dividend or other distribution will be adjusted by way of a deduction from such exercise price of an amount equal to the value per common share of any such dividend or other distribution. In January 2008 the exercise price for all unvested warrants was automatically adjusted downwards by $1.10 per warrant share to reflect the strategic dividend declared on December 10, 2007 and paid to shareholders of record on January 11, 2008. Dividends declared are discussed in note 21.

6. employee benefits continued

management team ordinary warrants ("ordinary warrants")

Ordinary warrants do not have associated performance criteria. 25% of such warrants vested immediately upon issuance. Thereafter, 25% of such warrants vest on the first, second and third anniversary of the grant date.

management team performance warrants ("performance warrants")

Performance warrants vest over a four year period and are dependent on certain performance criteria with specific measurement dates of December 31, 2007, December 31, 2008 and December 31, 2009. A maximum of 50% of performance warrants will vest only on achievement of a fully diluted book value per share in comparison to a required appreciation threshold at certain dates. A maximum of 50% of performance warrants will vest only on achievement of an internal rate of return ("IRR") in comparison to a required IRR at certain dates. Based on the performance criteria for the December 31, 2007 measurement date 802,935 performance warrants lapsed.

warrants	number thousands	weighted average exercise price U.S. $
allocated as at december 31, 2005	14,463	$5.00
allocated during the period	4,834	$5.00
allocated as at december 31, 2006	19,297	$5.00
allocated during the period	648	$5.00
allocated as at december 31, 2007	19,945	$5.00
exercisable as at december 31, 2007	9,658	$5.00

The fair value of warrants granted for all periods was $2.62 per share as there have been no further issues. A share-based payment expense of $9.3 million (2006 – $20.5 million) is included in other operating expenses in the consolidated income statement.

long-term incentive plan ("LTIP")

Until January 4, 2008 options could be granted under the LTIP at the discretion of the Remuneration Committee. On January 4, 2008 LHL's shareholders in a Special General Meeting voted in favour of the LHL Board's proposal to close the LTIP to future awards of options and to replace the LTIP with a Restricted Share Scheme ("RSS"). Options granted under the LTIP were limited to 5% of the fully diluted common share capital in issue at the Initial Public Offering date, assuming 5% management warrants are also in issue. All options issued will expire ten years from date of issue. The exercise price for options issued prior to 2007 is equal to or greater than the average closing price of the shares on the twenty previous trading days prior to grant. The exercise price for options awarded in 2007 is equal to the closing price of the shares by reference to a single valuation date occurring five days after the end of the close period ("close period" as defined in the Glossary to the AIM Rules for Companies – February 2007) most recently concluded prior to grant or five days after the decision to make the award if such decision was made outside a close period.

The range of exercise prices for options awarded under the LTIP are as follows:

december 31, 2007		december 31, 2006	
low	high	low	high
£3.25	£3.55	£3.25	£3.55
$6.50	$7.26	$6.37	$6.95

25% of options vest on each of the first, second, third and fourth anniversary of the grant date. There are no associated performance criteria. Settlement is at the discretion of the Group and may be in cash or shares.

In 2007, certain members of staff were issued options to purchase 4,590,105 common shares (2006 – 2,503,613). Options to purchase 12,709 common shares (2006 – 101,670) were forfeited during the period (see note 22).

6. employee benefits continued

The fair value of each option was estimated on the date of grant using the Black-Scholes option-pricing model. Assumptions used for valuation of these grants were as follows: risk free interest rate range of 3.5% – 5.125%; an expected life of six years; volatility of 30% being the maximum contractual rate; dividend yield of nil; the Group will settle in shares; no forfeitures, other than leavers which are assumed to be 10% of total employees, and no dilutive events.

options	number thousands	weighted average exercise price U.S. $
outstanding as at december 31, 2006	2,402	$6.56
forfeited during the period	(13)	$7.11
granted during the period	4,590	$7.04
outstanding as at december 31, 2007	6,979	$6.88
exercisable as at december 31, 2007	600	$6.56

The weighted fair value of options granted during the period ended December 31, 2007 was $2.77 per option (2006 – $2.32). A share-based payment expense of $5.1 million (2006 – $2.0 million) is included in other operating expenses in the consolidated income statement.

On January 4, 2008 the LHL shareholders also voted to give the Remuneration Committee the discretionary power to adjust the option exercise price to neutralise the devaluing impact of dividend payments on the value of options. On February 14, 2008 the Board of Directors exercised this discretionary power and adjusted the exercise price by $1.10 or £0.5622 per option. The resulting charge to the consolidated income statement will be approximately $1.2 million in 2008 and a $nil impact to shareholders' equity.

7. results of operating activities

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

	2007 $m	2006 $m
depreciation on owned assets	1.4	0.6
operating lease charges	1.8	1.1
auditors remuneration		
– group audit fees	1.3	0.7
– other services	0.2	0.3
total	**4.7**	**2.7**

Fees paid to the Group's auditors for other services are approved by the Group's Audit Committee. Such fees comprise the following amounts:

	2007 $m	2006 $m
tax advice	0.1	0.1
FSA regulatory advice	–	0.2
other	0.1	–
total	**0.2**	**0.3**

8. tax

Bermuda

LHL, LICL and LICUKL have received an undertaking from the Bermuda government exempting them from all Bermuda local income, withholding and capital gains taxes until March 28, 2016. 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 United States and, accordingly, does not expect to be subject to United States taxation on its income or capital gains.

United Kingdom

The UK subsidiaries are subject to normal UK corporation tax on all their profits.

tax charge	2007 $m	2006 $m
corporation tax charge for the year	2.1	1.0
adjustments in respect of prior year corporation tax	0.1	–
deferred tax for the year	(1.1)	(0.8)
adjustments in respect of prior year deferred tax	(0.1)	–
total	**1.0**	**0.2**

tax reconciliation	2007 $m	2006 $m
profit before tax	391.9	159.5
less profit not subject to tax	(389.0)	(161.6)
profits subject to tax	2.9	(2.1)
UK corporation tax at 30%	0.9	(0.6)
expenses not allowed for tax deduction	0.1	–
other expense timing differences	(0.1)	0.8
deferred tax at a rate other than 30%	0.1	–
total	**1.0**	**0.2**

The standard rate of corporation tax in the UK is 30% (2006 – 30%). The current tax charge as a percentage of the Group's profit before tax is 0.3% (2006 – 0.1%) due to the different tax paying jurisdictions throughout the Group.

A current corporation tax expense of $0.4 million was charged to equity during the year (2006 – $nil), which relates to unrealised investment gains recognised directly in equity.

taxation payable	2007 $m	2006 $m
UK corporation tax payable	1.2	1.0

9. deferred tax

	2007 $m	2006 $m
deferred tax assets	2.0	0.8
deferred tax liabilities	–	–
net deferred tax asset	**2.0**	**0.8**

In 2007, the UK government enacted a change in the corporation tax rate from 30% to 28% that will become effective from April 1, 2008. A deferred tax expense of $0.1 million was recognised during the period with respect to the change in corporation tax rate to 28%. Deferred tax on temporary differences that are expected to unwind in 2008 have a tax rate of 28.5% applied to them and those that unwind in subsequent years have a rate of 28%.

The deferred tax asset is recognised to the extent that the realisation of the related tax benefit is probable. It is anticipated that the Lancashire UK group of companies will continue to be in a profitable position in 2008, thus the entire deferred tax asset is recognised.

The deferred tax asset relates to the warrants and options benefit schemes. All deferred tax assets and liabilities are classified as non-current.

The movement on the total net deferred tax asset is as follows:

	2007 $m	2006 $m
as at january 1	0.8	–
income statement credit	1.2	0.8
as at december 31	**2.0**	**0.8**

10. cash and cash equivalents

	2007 $m	2006 $m
cash at bank and in hand	22.8	50.0
cash equivalents	714.5	350.1
total	**737.3**	**400.1**

Cash equivalents have an original maturity of three months or less. The carrying amount of these assets approximates their fair value.

Cash and cash equivalents totaling $22.1 million (2006 – $10.9 million) were on deposit in various trust accounts for the benefit of policyholders or counter-parties to agreements to cover their credit risk.

Cash and cash equivalents totaling $36.9 million (2006 – $25.1 million) were on deposit as collateral in favour of letters of credit issued for the benefit of policyholders or counter-parties to cover their credit risk.

11. investments

as at december 31, 2007	$m cost or amortised cost	$m gross unrealised gain	$m gross unrealised loss	$m estimated fair value
fixed income securities				
– short-term investments	0.7	–	–	0.7
– U.S. treasuries	251.6	2.9	(0.1)	254.4
– U.S. government agency debt	206.5	2.8	–	209.3
– U.S. government agency mortgage backed securities	237.2	4.0	(0.1)	241.1
– non-agency mortgage backed securities	7.0	–	–	7.0
– corporate bonds	341.1	3.5	(1.3)	343.3
– convertible debt securities	13.9	0.3	(0.3)	13.9
total fixed income securities – available for sale	**1,058.0**	**13.5**	**(1.8)**	**1,069.7**
equity securities – available for sale	62.2	12.1	(2.7)	71.6
total available for sale securities	**1,120.2**	**25.6**	**(4.5)**	**1,141.3**
fixed income securities – at fair value through income	23.1	0.8	(0.4)	23.5
other investments – at fair value through income (note 20)	4.4	0.4	(0.4)	4.4
total investments	**1,147.7**	**26.8**	**(5.3)**	**1,169.2**

as at december 31, 2006	$m cost or amortised cost	$m gross unrealised gain	$m gross unrealised loss	$m estimated fair value
fixed income securities				
– short-term investments	6.9	–	–	6.9
– U.S. treasuries	30.8	–	–	30.8
– U.S. government agency debt	150.3	0.2	(0.1)	150.4
– asset backed securities	121.0	0.2	(0.1)	121.1
– U.S. government agency mortgage backed securities	214.0	0.9	(0.3)	214.6
– non-agency mortgage backed securities	151.6	1.1	(0.2)	152.5
– corporate bonds	190.2	1.1	(0.2)	191.1
– convertible debt securities	28.9	–	–	28.9
total fixed income securities – available for sale	**893.7**	**3.5**	**(0.9)**	**896.3**
equity securities – available for sale	64.2	7.0	(0.9)	70.3
total available for sale securities	**957.9**	**10.5**	**(1.8)**	**966.6**
other investments – at fair value through income (note 20)	9.7	1.9	(0.1)	11.5
total investments	**967.6**	**12.4**	**(1.9)**	**978.1**

Equity securities and other investments are deemed non-current. Fixed income maturities are presented in the risk disclosures section on page 69.

12. investment in associate

On June 15, 2006 the Group made an investment of $20.0 million which represented a 21.1% interest in Sirocco Holdings Limited ("Sirocco"), a company incorporated in Bermuda. Sirocco's operating subsidiary, Sirocco Reinsurance Limited ("Sirocco Re"), is authorised as a Class 3 insurer by the BMA. Sirocco Re was established to assume Gulf of Mexico energy risks from the Group. Sirocco is an unquoted investment and its shares do not trade on any active market. Sirocco is carried at $22.9 million (2006 – $23.2 million), representing management's best estimate of fair value based on Sirocco Re's audited financial statements as at July 15, 2007 and subsequent management information. Management believes carrying value approximates fair value.

	2007 $m	2006 $m
as at january 1	23.2	–
acquisition	–	20.0
share of profit of associate	6.2	3.2
dividends received	(6.5)	–
as at december 31	**22.9**	**23.2**

Key financial information for Sirocco for the years ended December 31, 2007 and 2006 is as follows:

	2007 $m	2006 $m
assets	117.0	124.6
liabilities	8.2	14.3
shareholders' equity	108.8	110.3
revenues	36.4	18.6
profit	29.8	15.2

Effective December 31, 2007, the reinsurance agreement entered into with Sirocco Re was commuted for a fee to the Group of $1.3 million. The net impact of the commutation was a $1.9 million credit to income. Sirocco is expected to liquidate during 2008 and therefore the investment is deemed a current asset.

13. insurance and reinsurance contracts

insurance liabilities	$m	$m	$m
	unearned premiums	**other payables**	**total**
as at december 31, 2005	2.6	–	2.6
current year	323.1	–	323.1
other	–	5.2	5.2
as at december 31, 2006	**325.7**	**5.2**	**330.9**
net deferral for:			
prior years	(281.6)	–	(281.6)
current year	337.7	–	337.7
other	–	11.3	11.3
as at december 31, 2007	**381.8**	**16.5**	**398.3**

13. insurance and reinsurance contracts continued

losses and loss adjustment expenses	$m	$m	$m
	losses and loss adjustment expenses	losses and loss adjustment expenses recoverable	net losses and loss adjustment expenses
as at december 31, 2005	**–**	**–**	**–**
net incurred losses for:			
current year	39.1	–	39.1
as at december 31, 2006	**39.1**	**–**	**39.1**
net incurred losses for:			
prior years	(4.4)	–	(4.4)
current year	154.4	(3.7)	150.7
exchange adjustments	0.4	0.1	0.5
incurred losses and loss adjustment expenses	**150.4**	**(3.6)**	**146.8**
net paid losses for:			
prior years	4.7	–	4.7
current year	5.2		5.2
paid losses and loss adjustment expenses	**9.9**	**–**	**9.9**
as at december 31, 2007	**179.6**	**(3.6)**	**176.0**

reinsurance assets and liabilities	$m	$m	$m	$m
	unearned premiums	other payables	other receivables	total
as at december 31, 2005	**–**	**–**	**–**	**–**
current year	19.1	–	–	19.1
other	–	(0.8)	–	(0.8)
as at december 31, 2006	**19.1**	**(0.8)**	**–**	**18.3**
net deferral for:				
prior years	(19.1)	–	–	(19.1)
current year	19.6	–	–	19.6
other	–	(4.9)	8.2	3.3
as at december 31, 2007	**19.6**	**(5.7)**	**8.2**	**22.1**

Further information on the calculation of loss reserves and the risks associated with them is provided in the risk disclosures section, which starts on page 57. 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. Management believe that the loss reserves established are adequate, however a 20% increase in estimated losses would lead to a $35.9 million (2006 – $7.8 million) increase in loss reserves. There was no change to reserving assumptions during the year.

13. insurance and reinsurance contracts continued

The split of losses and loss adjustments expenses between notified outstanding losses, additional case reserves assessed by management and losses incurred but not reported is shown below:

	2007 $m	2006 $m
outstanding losses	56.0	1.2
additional case reserves	17.8	–
losses incurred but not reported	105.8	37.9
losses and loss adjustment expenses	**179.6**	**39.1**

It is estimated that our reserve for unpaid losses and loss adjustment expenses has a 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 underlying risks and lack of known loss events occurring during the period to December 31, 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	2007 $m	2006 $m
gross claims		
estimate of ultimate liability[1]		
at end of accident year	154.8	39.1
one year later	–	34.7
current estimate of cumulative liability	**154.8**	**34.7**
payments made	**5.2**	**4.7**
total gross liability	**149.6**	**30.0**

accident year	2007 $m	2006 $m
reinsurance		
estimate of ultimate recovery[1]		
at end of accident year	3.6	–
one year later	–	–
current estimate of cumulative recovery	**3.6**	**–**
total gross recovery	**3.6**	**–**

13. insurance and reinsurance contracts continued

accident year	2007 $m	2006 $m
net claims		
estimate of net ultimate liability(1)		
at end of accident year	151.2	39.1
one year later	–	34.7
current estimate of net cumulative liability	**151.2**	**34.7**
payments made	**5.2**	**4.7**
total net liability	**146.0**	**30.0**

(1) adjusted for revaluation of foreign currencies at the exchange rate as at December 31, 2007.

The total favourable development on losses and loss adjustment expenses from prior years was $4.4 million (2006 – $nil). There have been no events during the year that significantly impacted the Group.

14. insurance, reinsurance and other receivables

	2007 $m	2006 $m
inwards premium receivable from insureds and cedants	198.2	173.7
accrued interest receivable	9.8	7.5
reinsurance assets – other receivables	8.2	–
other receivables	3.8	6.3
reinsurance assets – reinsurance recoveries	3.6	–
total receivables	**223.6**	**187.5**

Other receivables consist primarily of unsettled investment trades. All receivables are considered current other than $10.6 million (2006 – $8.9 million) of inwards premium receivable related to multi-year contracts. The carrying value approximates fair value due to the short-term nature of the receivables. There is no significant concentration of credit risk within the Group's receivables.

15. deferred acquisition costs

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

	$m
as at december 31, 2005	**0.5**
net deferral during the year	91.0
expense incurred for the year	(40.0)
as at december 31, 2006	**51.5**
net deferral during the year	101.9
expense incurred for the year	(95.6)
as at december 31, 2007	**57.8**

16. insurance, reinsurance and other payables

	2007 $m	2006 $m
dividends payable	239.1	–
other payables	57.1	20.8
total other payables	**296.2**	**20.8**
insurance contracts – other payables	16.5	5.2
amounts payable to reinsurers	5.7	0.8
total payables	**318.4**	**26.8**

Dividends payable are discussed in note 21. Other payables include unsettled investment trades, unsettled share repurchases 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.

17. deferred acquisition costs ceded

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

	$m
as at december 31, 2005	**–**
net deferral during the year	7.6
income recognised for the year	(5.1)
as at december 31, 2006	**2.5**
net deferral during the year	19.7
income recognised for the year	(19.1)
as at december 31, 2007	**3.1**

18. property, plant and equipment

	office furniture and equipment $m	leasehold improve-ments $m	IT equipment $m	total $m
cost				
as at january 1, 2006	–	–	0.4	0.4
additions	1.0	0.6	1.0	2.6
as at december 31, 2006	**1.0**	**0.6**	**1.4**	**3.0**
additions	0.5	0.6	0.2	1.3
as at december 31, 2007	**1.5**	**1.2**	**1.6**	**4.3**
accumulated depreciation				
as at january 1, 2006	–	–	–	–
charge for the period	0.2	0.1	0.3	0.6
as at december 31, 2006	**0.2**	**0.1**	**0.3**	**0.6**
charge for the period	0.7	0.2	0.5	1.4
as at december 31, 2007	**0.9**	**0.3**	**0.8**	**2.0**
net book value				
as at december 31, 2006	**0.8**	**0.5**	**1.1**	**2.4**
as at december 31, 2007	**0.6**	**0.9**	**0.8**	**2.3**

19. long-term debt and financing arrangements

	2007 $m	2006 $m
subordinated loan note of $97.0 million	97.0	97.0
subordinated loan note of €24.0 million	35.3	31.6
carrying value and fair value	**132.3**	**128.6**

On December 15, 2005 the Group issued, via a trust company, $97 million in aggregate principal amount of subordinated loan notes and €24 million in aggregate principal amount of subordinated loan notes ("long-term debt") at an issue price of $1,000 and €1,000 of their principal amounts respectively. Due to the floating interest rates, the carrying value approximates fair value.

The U.S. dollar subordinated loan notes are repayable on December 15, 2035 with a prepayment option available from March 15, 2011. Prior to March 15, 2011, upon the occurrence and during the continuation of a "Special Event", LHL may, at its option, redeem the securities, in whole but not in part, at a sliding scale redemption price. A Special Event is a change in the tax and/or investment status of the issuing trust. Interest on the principal is based on a set margin (3.7%) above the variable Libor rate and is payable quarterly.

The Euro subordinated loan notes are repayable on June 15, 2035 with a prepayment option available from March 15, 2011. Prior to this time prepayment would only be available in the event of a "Special Event". Interest on the principal is based on a set margin (3.7%) above the variable Euribor rate and is payable quarterly.

The Group is exposed to cash flow interest rate risk and currency risk. Further information is provided in the risk disclosures section from page 63.

The interest accrued on the loans payable was $0.5 million (2006 – $0.5 million) at the balance sheet date. The interest expense for the year was $11.6 million (2006 – $10.6 million).

19. long-term debt and financing arrangements continued

letters of credit

As both LICL and LICUKL are non-admitted insurers or reinsurers throughout the U.S., the terms of certain contracts require them to provide letters of credit to policyholders as collateral. On May 17, 2006, LHL and LICL entered into a syndicated collateralised three year credit facility in the amount of $350.0 million. This was re-financed on July 16, 2007 to a syndicated collateralised five year credit facility in the amount of $200.0 million. The facility contains a $75.0 million loan sub-limit available for general corporate purposes.

The facility is available for the issue of letters of credit ("LOCs") to ceding companies. The facility is also available for LICL to issue LOCs to LICUKL to collateralise certain insurance balances. As at December 31, 2007 letters of credit totalling $61.9 million had been issued to LICUKL (2006 – $nil). Letters of credit totalling $37.0 million (2006 – $25.1 million) had been issued to third parties by LICL and there was no outstanding debt under this facility (2006 – $nil). Letters of credit are required to be fully collateralised. As at December 31, 2007 $110.8 million (2006 – $25.1 million) of collateral had been posted to a trust account, the beneficiaries of which are the banks who have issued letters of credit on our behalf. Under the terms of the facility, investments in the trust account are subject to various discounts to allow for market fluctuations in the investments provided as security. The discounts are determined per investment type.

The facility terms also include standard default and cross default provisions which require certain covenants to be adhered to. These include the following:

(i) a financial strength rating of at least B++; and
(ii) a maximum debt to capital ratio of 30%, where the current long-term debt issuance is excluded from this calculation.

As at December 31, 2007 and 2006 the Group was in compliance with all covenants under this facility.

20. derivative financial instruments

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 through income. During the period, $1.3 million (2006 – $1.0 million) was charged to financing costs in respect of the interest rate swap. The net fair value position owed by the Group was $2.2 million (2006 – $0.9 million). The Group has the right to net settle these instruments. The next cash settlement due on these instruments is negligible (2006 – negligible) and is due on March 15, 2008. The counter-party requires collateralisation of positions in excess of $2.0 million. These instruments will expire on March 15, 2011.

The Group invests a small portion of its investment portfolio in convertible debt securities. The option to convert is an embedded derivative, which is required to be bifurcated from the host contract with changes in estimated fair value recorded through income, unless the security has been designated as fair value through income. As at December 31, 2007 the derivative instrument was valued at $4.4 million (2006 – $11.5 million), with changes in net unrealised losses of $1.8 million (2006 – $1.8 million gain) reflected in the consolidated income statement in other investment income.

The Group entered into a contingent equity physically settled put option on June 13, 2007. The option gave the Group the right to put up to 9,786,000 shares to the counter-party at a guaranteed price of $5.00 per share or the available market rate, if higher. The option expired on November 30, 2007. There was no obligation to exercise the option. During the period $1.1 million was charged to financing costs in respect of the option, and $1.5 million was charged to other investment income in respect of the value of the derivative at inception of the contract which expired unexercised.

21. share capital

authorised ordinary shares of $0.50 each	number	$m
as at december 31, 2007 and 2006	**3,000,000,000**	**1,500**

allocated, called up and fully paid	number	$m
as at december 31, 2005	**195,713,902**	**97.9**
shares issued	113,219	–
shares repurchased	(83,775)	–
as at december 31, 2006	**195,743,346**	**97.9**
shares issued	627,087	0.1
shares repurchased	(14,087,338)	(6.9)
as at december 31, 2007	**182,283,095**	**91.1**

On May 15, 2007, 127,087 shares were issued and 94,447 repurchased as part of a cashless exercise of warrants (see note 22).

On August 15, 2007, 500,000 shares were issued and 351,975 repurchased as part of a cashless exercise of warrants (see note 22).

On October 29, 2007 the Board of Directors authorised a $100.0 million share repurchase program[1]. Shares were repurchased and cancelled as follows:

date	number of shares	share price	$m
november 9, 2007	6,026,925	£3.55	45.1
november 15, 2007	2,000,000	£3.50	14.3
november 15, 2007	3,000,000	£3.50	21.6
december 5, 2007	103,000	£3.48	0.7
december 6, 2007	30,000	£3.48	0.2
december 7, 2007	80,563	£3.52	0.6
december 10, 2007	153,000	£3.60	1.1
december 11, 2007	500,000	£3.62	3.7
december 12, 2007	430,000	£3.60	3.2
december 13, 2007	362,756	£3.60	2.7
december 14, 2007	425,000	£3.64	3.2
december 17, 2007	446,100	£3.57	3.2
december 18, 2007	83,572	£3.55	0.6
total	**13,640,916**		**100.2**

(1) Due to the movement of exchange rates between trade and settlement dates, the amount paid for the share repurchase program was $100.2 million versus the authorised program of $100.0 million. The variance was ratified by the Board of Directors on February 14, 2008.

21. share capital continued

Shares were repurchased from significant founding shareholders as follows:

(i) On November 9, 2007 the Group purchased 6,026,925 of its common shares of U.S. $0.50 par value per share at a price of £3.55 per common share. The sellers were SAB Capital Partners, L.P., SAB Capital Partners II, L.P., and SAB Overseas Master Fund, L.P. (together "SAB"). As a result of the repurchase SAB is no longer a significant shareholder in the Group.

(ii) On November 15, 2007 the Group purchased 5,000,000 of its common shares of U.S. $0.50 par value per share at a price of £3.50 per common share. As part of the transaction, the Group repurchased 3,000,000 of its common shares from Och-Ziff Management, L.P. and affiliated investment funds (together, "Och-Ziff"). As a result of the repurchase Och-Ziff owned 15,336,176 common shares representing 8.29% of the Group's issued share capital after the repurchases.

The share repurchase program was concluded prior to December 31, 2007. $10.5 million of proceeds remained to be settled at the balance sheet date.

On December 10, 2007 the Board of Directors authorised the payment of a strategic dividend of $1.10 (£0.5622) per common share to be paid in pounds sterling to shareholders of record on January 11, 2008 with a settlement date of January 25, 2008. The total dividend amount payable is $239.1 million (2006 – $nil) and is recorded in other payables in the consolidated balance sheet.

22. warrants and options

	other warrants number	management ordinary warrants number	management performance warrants number	options number
as at december 31, 2005	**25,417,136**	**12,708,695**	**7,625,218**	**–**
issued	–	–	–	2,503,613
forfeited	–	–	–	(101,670)
exercised	(113,219)	–	–	–
as at december 31, 2006	**25,303,917**	**12,708,695**	**7,625,218**	**2,401,943**
issued	–	–	–	4,590,105
forfeited	–	–	–	(12,709)
exercised	–	(627,087)	–	–
as at december 31, 2007	**25,303,917**	**12,081,608**	**7,625,218**	**6,979,339**

warrants

All warrants issued will expire on December 16, 2015 and are exercisable at an initial price per share of $5.00, equal to the price per share paid by investors in the initial public offering. The warrant holder may request a cashless exercise. The method of settlement is at the discretion of the Group and may be in cash or shares. On January 11, 2008, pursuant to the terms of the warrants, the exercise price for unvested warrants was adjusted downwards by $1.10 per warrant, being the equivalent of the strategic dividend declared on December 10, 2007.

founders

On December 28, 2006 a founding investor exercised 113,219 warrants at a strike price of $5.00 per share. This was a cashless exercise and resulted in the Group issuing a further 29,444 common shares at $0.50 per share.

sponsor

On November 30, 2006 the Group's sponsor sold its entire holding of warrants to an unrelated third party. Subsequent to this transaction, the sponsor is no longer deemed a related party.

Management warrants and options are discussed in note 6.

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 period were $1.8 million (2006 – $1.1 million). Lease payments under non-cancellable operating leases are as follows:

	2007 $m	2006 $m
due in less than one year	1.9	1.2
due between one and five years	2.3	4.5
due in more than five years	–	0.3
total	**4.2**	**6.0**

In January 2008 LICL entered into an agreement to lease new office premises in Bermuda. The lease will be for a five year period and is due to commence in 2009 upon the expiry of LICL's existing premises leases.

24. earnings per share

Basic earnings per share amounts are calculated by dividing net profit for the period attributable to shareholders by the weighted average number of common shares outstanding during the year.

Diluted earnings per share amounts are calculated by dividing the net profit or loss attributable to shareholders by the weighted average number of common shares outstanding during the year plus the weighted average number of common shares that would be issued on the conversion of all potentially dilutive common shares into common shares.

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

	2007 $m	2006 $m
profit for the year attributable to equity shareholders	390.9	159.3

	number of shares thousands	number of shares thousands
basic weighted average number of shares	194,201	195,714
potentially dilutive shares related to share-based compensation	10,959	6,325
diluted weighted average number of shares	205,160	202,039

Share-based payments are only treated as dilutive when their conversion to common shares would decrease earnings per share or increase loss per share from continuing operations. In the current period, incremental shares from the assumed exercising of management performance warrants, where relevant performance criteria are based on future dates, are not included in calculating dilutive shares. In addition, the options which are antidilutive are not included in the number of potentially dilutive shares.

In the prior period, incremental shares from the assumed exercising of management performance warrants are not included in calculating dilutive shares as the relevant criteria had not been met. In addition, the options are antidilutive and are therefore not included in the number of potentially dilutive shares.

25. related party disclosures

The consolidated financial statements include Lancashire Holdings Limited and the subsidiaries listed below:

name	domicile
Lancashire Insurance Company Limited	Bermuda
Lancashire Insurance Marketing Services Limited	United Kingdom
Lancashire Holdings Financing Trust I	United States
Lancashire Insurance Holdings (UK) Limited	United Kingdom
Lancashire Insurance Company (UK) Limited	United Kingdom
Lancashire Insurance Services Limited	United Kingdom
Lancashire Marketing Services (Middle East) Limited	United Arab Emirates

All subsidiaries are wholly owned, either directly or indirectly.

The Group has issued loan notes via a trust vehicle – Lancashire Holdings Financing Trust I (the "Trust") (see note 19). The Group effectively has 100% of the voting rights in the Trust. These rights are subject to the property trustee's obligations to seek approval of the holders of the Trust'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 the Trust is limited by the Trust Agreement, the Trust was set up by the Group with the sole purpose of issuing the loan notes and is in essence controlled by the Group, and is therefore consolidated.

key management compensation

Remuneration for key management for the year ending December 31 was as follows:

	2007 $m	2006 $m
short-term compensation	11.3	4.5
share-based compensation	10.8	12.1
total	**22.1**	**16.6**

transactions with directors and shareholders

Significant shareholders have a representation on the Board of Directors. During the year the Group paid $1.2 million (2006 – $0.9 million) in directors' fees and expenses, including $0.5 million (2006 – $0.4 million) to directors representing significant shareholders. A further $0.2 million (2006 – $0.3 million) was paid in respect of monitoring fees for significant founding shareholders.

transactions with associate

During the year the Group ceded $25.1 million (2006 – $29.9 million) of premium to Sirocco Re and received $11.6 million (2006 – $5.4 million) of commission income. As at December 31, the following amounts with Sirocco Re were included in the consolidated balance sheet:

	2007 $m	2006 $m
reinsurance assets		
other receivables	8.2	–
unearned premium on premium ceded	–	11.8
amounts payable to reinsurers	–	0.8
deferred acquisition costs ceded	–	2.2

Contingent profit commission, based on the ultimate performance of Sirocco Re at December 31, 2006 was $2.6 million. The final commission of $7.8 million is included in other receivables of $8.2 million.

25. related party disclosures continued

transactions with Lancashire Foundation

On December 1, 2007 648,143 unallocated ordinary warrants were allocated to the Lancashire Foundation, a charity established under Bermuda Law. As a result the initial funding of the Lancashire Foundation (the "Foundation") was achieved with no impact on LHL's return on equity.

As at December 31, 2007, LHL had loaned the Foundation $0.4 million (2006 – $nil) evidenced by limited resource promissory notes executed by the Foundation Trustees in favour of LHL. The loans were made to fund the Foundation's activities pending the exercise of the warrants donated to the Foundation. They are interest free and payable on demand.

26. non-cash transactions

The unsettled element of the share repurchase discussed in note 21 is not reflected in the cash flow statement. In addition, the dividend declared on December 10, 2007 is not reflected, as the settlement date is January 25, 2008. The cash flows on both of these transactions are recorded in 2008.

On November 2, 2006, following shareholder approval, LHL transferred $850.0 million from share premium to contributed surplus.

27. statutory requirements and dividend restrictions

As a holding company, LHL relies on dividends from its subsidiaries to provide cash flow required for debt service and dividends to shareholders. The subsidiaries' 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 subsidiaries these are based principally on the amount of premiums written and reserves for losses and loss expenses, subject to overall minimum solvency requirements. 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 subsidiaries is as follows:

as at december 31, 2007	$m	£m	$m
	LICL	LICUKL	LMSMEL
statutory capital and surplus	1,387.1	55.4	0.3
minimum required statutory capital and surplus	311.1	13.4	0.1

as at december 31, 2006	$m	£m	$m
	LICL	LICUKL	LMSMEL
statutory capital and surplus	1,079.2	56.3	–
minimum required statutory capital and surplus	271.1	7.4	–

For LICUKL, various capital calculations are performed and an individual assessment of LICUKL's capital needs (an "ICA") is presented to the FSA. The FSA then considers the capital calculations and issues an individual capital guidance ("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 by the regulations of the BMA to maintain a minimum liquidity ratio, whereby relevant assets, as defined in the regulations, must exceed 75% of relevant liabilities. As at December 31, 2007 and 2006 the liquidity ratio was met.

As at December 31, 2007 and 2006 the capital requirements of all three regulatory jurisdictions were met.

28. presentation

Certain amounts in the December 31, 2006 consolidated financial statements have been re-presented to conform with the current year's presentation and format. These changes in presentation have no effect on the previously reported net profit.

annual general meeting

Notice of this year's annual general meeting and the form of proxy accompany this Annual Report. If you have any queries regarding the notice or return of the proxy please contact Greg Lunn, (Company Secretary and General Counsel) at Lancashire, Mintflower Place, 8 Par-la-Ville Road, Hamilton HM 08, Bermuda, Tel: (441) 278 8953, Email: greg.lunn@lancashiregroup.com

further information

Further information about the Group including this Annual Report and consolidated financial statements, press releases and the Company's share price is available on our website at www.lancashiregroup.com

note regarding forward-looking statements

Certain statements and indicative projections that are not based on current or historical facts are forward-looking in nature including without limitation, statements containing 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 Group's 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 achievments 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 we write; the premium rates available at the time of such renewals within our targeted business lines; the absence of large or unusually frequent loss events; the impact that our 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 our underwriting, reserving or investment practices have anticipated; the reliability of, and changes in assumptions to, catastrophe pricing, accumulation and estimated loss models; loss of key personnel; a decline in our operating subsidiaries' rating with A.M. Best company; 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 created by the sub-prime and credit crisis; a rating downgrade of, or a market decline in, securites in our investment portfolio; changes in governmental regulations or tax laws in jurisdictions where Lancashire conducts business; Lancashire or its bermudian subsidiary becoming subject to income taxes in the United States or the United Kingdom; and the effectiveness of our loss limitation methods. Any estimates relating to loss events involve the exercise of considerable judgement and reflect a combination of ground-up evaluations, information available to date from brokers and insureds, market intelligence, initial tentative loss reports and other sources. Judgements in relation to flood losses involve complex factors potentially contributing to this type of loss, and we caution as to the preliminary nature of the information used to prepare any such estimates.

These forward-looking statements speak only as at the date of publication of this document. Lancashire Holdings Limited expressly disclaims any obligation or undertaking (save as required to comply with any legal or regulatory obligations (including the AIM rules)) 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.

Lancashire Holdings Limited is committed to reducing the impact of its activities on the environment.

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