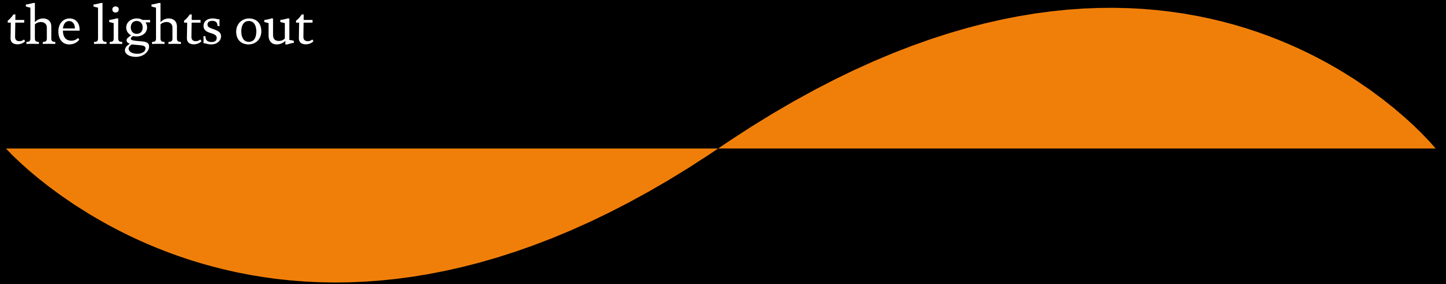
lancashire
HOLDINGS LIMITED

# Sometimes not losing money is more important than blowing the lights out



Annual Report & Accounts 2008

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## 2008 Highlights

### FINANCIAL HIGHLIGHTS

- Return on equity of 7.5 per cent (2007 – 31.7 per cent)
- Net profit of $97.5 million (2007 – $390.9 million)
- Gross premiums written of $638.1 million (2007 – $753.1 million)
- Combined ratio 86.3 per cent (2007 – 46.3 per cent)
- Total investment return of 3.1 per cent (2007 – 6.4 per cent)
- Capital returned to shareholders of $58.0 million via share repurchases (2007 – $100.2 million capital returned to shareholders via share repurchases. The Company also declared a strategic dividend of $239.1 million in 2007)

### OPERATING HIGHLIGHTS

- Strong underwriting discipline in softening market – 2008 gross premiums were reduced by 15.3 per cent compared to 2007.
- Strong underwriting performance in year that saw industry losses well above average – loss ratio of 61.8 per cent.
- Exceptional investment return in extremely challenging investment markets – achieved total return of 3.1 per cent.
- Solid operating performance and prudent capital management in 2008 means Lancashire is well positioned to fully capitalise on attractive trading conditions in 2009.

### OUTLOOK FOR 2009

Early indications are that there will be a broad-based improvement in pricing across most of the lines of business that the Company writes, together with improvements in terms and conditions. The Directors are confident that prospects for Lancashire for 2009 are strong.

# Introduction

Lancashire is a global provider of specialty insurance products operating in Bermuda, London and Dubai. We focus on short-tail, mostly on a direct basis, specialty insurance risks under the four general categories: property, energy, marine and aviation.

Our long-term goal is to achieve an above-average risk-adjusted return. So far this goal has been met. And more. Since inception we have compounded book value per share, including dividends, by an impressive 17.7 per cent. This was achieved despite giant natural catastrophes and even bigger man-made ones.

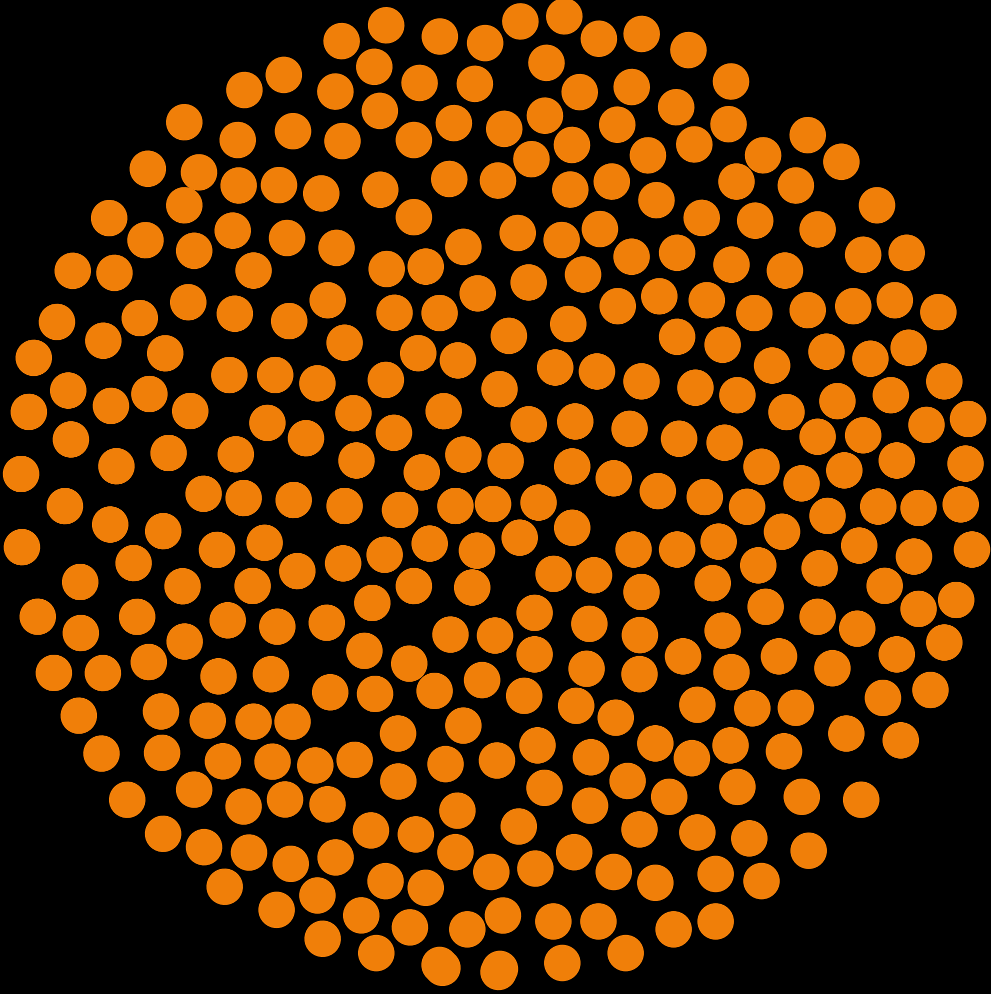
How did we do this? By keeping it simple.

- Underwriting comes first
- Maintain a strong balance sheet
- Stay nimble
- Manage capital through the cycle

# 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 provide a superior risk-adjusted return for shareholders.

**Objective met:** In 2008 there were lots of losses from lots of places in many of the segments in which we have significant participation. There was an unusually high level of large property risk losses, and there was an unusually high level of large energy losses. And of course there was the third largest insured hurricane loss since records began. Lancashire's loss ratio in 2008 was 61.8 per cent, one of the best results in the industry, and a testament to our underwriting team.



# Maintain a strong balance sheet

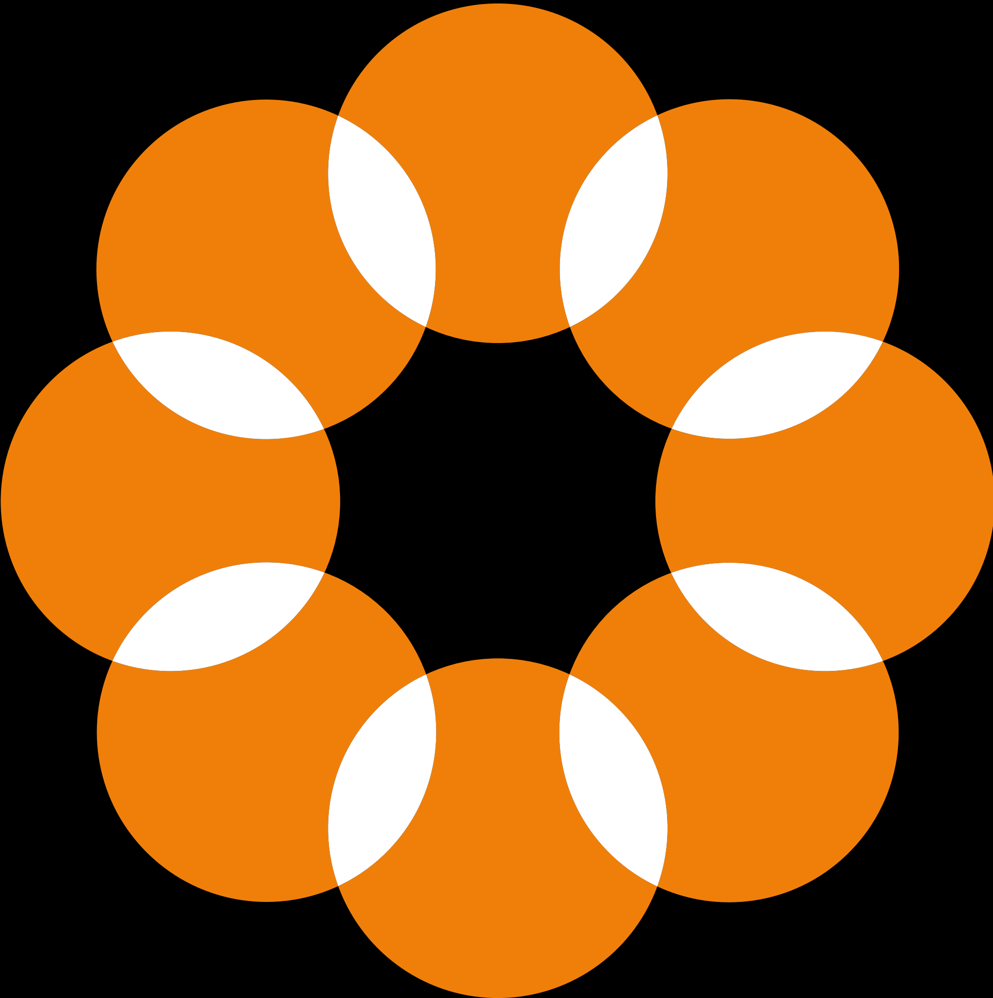
We have a range of risk tolerances, and our balance sheet must be sufficient at all times to meet those requirements. We aim to meet policyholders' claims promptly, accurately and completely. Our balance sheets should instill a high level of confidence in all stakeholders, including shareholders, regulators,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

**Objective met:** The insurance industry suffered a twin assault in 2008. Insurance losses were significant, from a myriad of sources. But the real story was the collapse of the financial markets. Our industry collectively forgot that risk exists on both sides of the balance sheet. Fortunately we didn't. Our investment philosophy has remained the same since day 1: "Don't lose your money". We are proud to have turned in a positive investment return of 3.1 per cent, and equally proud to have produced an overall 7.5 per cent Return on Equity. Consequently, Lancashire heads into 2009 with a very strong balance sheet.

# 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.

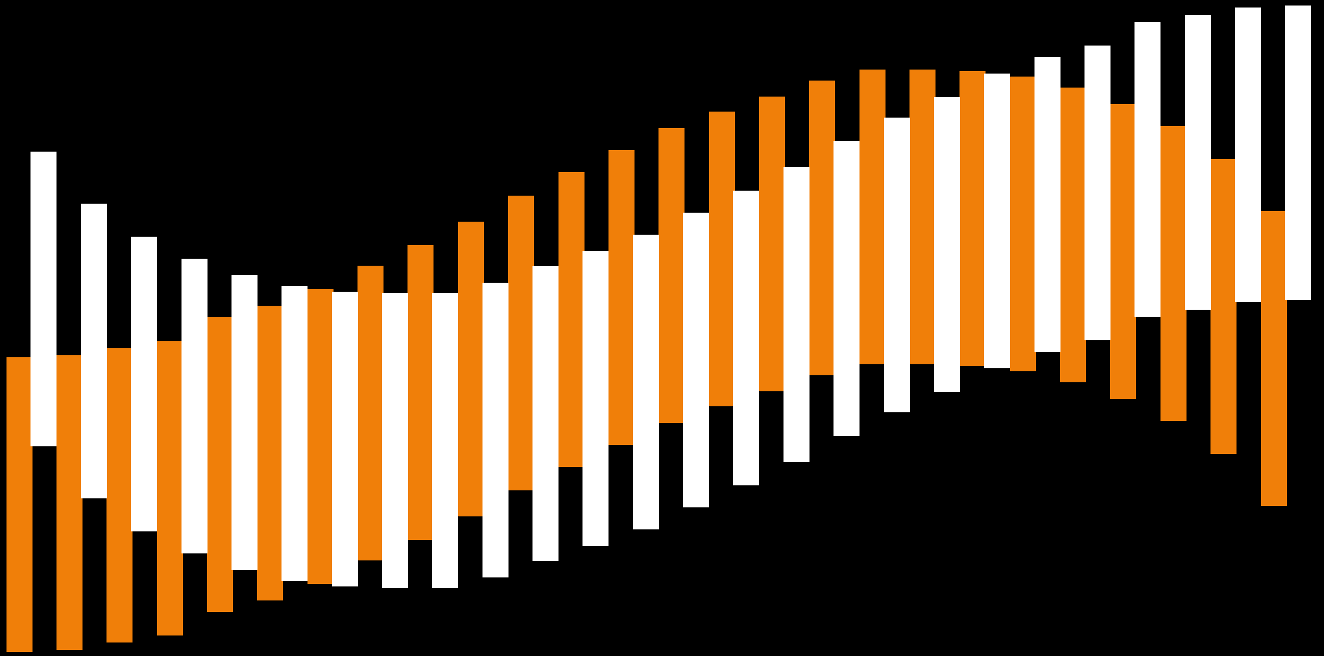
**Objective met:** We grew in the hard markets of 2006 and 2007. We shrank in the softening market of 2008. We have the people and the capital strength and the right market opportunities to grow once again in the hard market of 2009. Others just talk the talk. We walk the walk.



# Manage capital through the cycle

Underwriting opportunities and the risk they carry will drive capital levels, not the other way around. The world at large plays its part too. We plan to carry sufficient capital to support the risk we assume, and to take advantage of underwriting opportunities as and when they arise.

Objective met: As 2008 progressed, underwriting opportunities declined. As we said we would, we returned capital by repurchasing some of our own shares at prices which were accretive to book value. Whilst we will return capital when we don't have good ideas for its use, right now we have lots of ideas. A hard market is upon us and underwriting opportunities have increased. But we are also cognisant of the current market environment. A vital use of capital is to provide a buffer above minimum requirements. More than ever, that buffer should be a healthy one. It is at Lancashire.

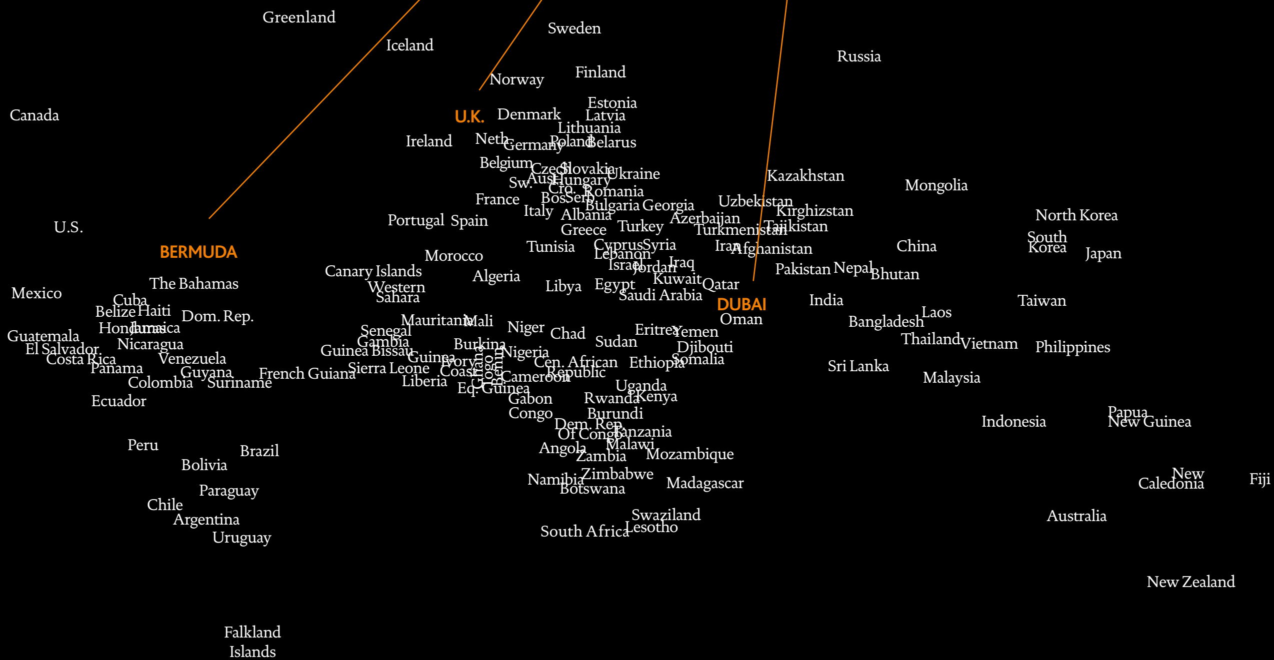


# Lancashire at a glance

## THE DAILY CALL

Lancashire holds a daily underwriting and marketing conference call to review underwriting submissions across all lines, to maximise marketing and cross-selling possibilities and to exchange market information. Representatives from the Group's offices in London, Bermuda and Dubai participate in the daily call.

## Where we're at




## HAMILTON, BERMUDA
41 Staff

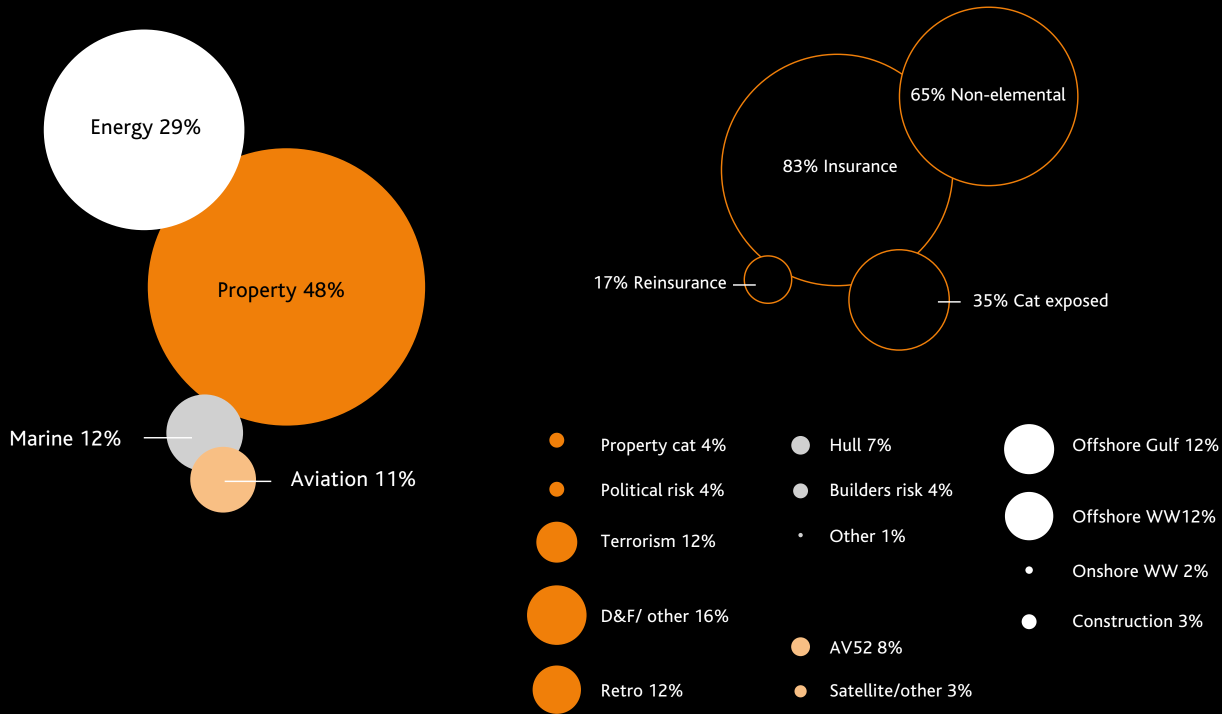
Established in 2005, Lancashire's corporate headquarters and original underwriting platform is based in Bermuda. Many of the Group's clients, which include some of the world's largest companies, insured with Lancashire from its beginnings in Bermuda.

## LONDON, UK
47 Staff

From its base in Fenchurch Street in the heart of the London insurance market, Lancashire's UK operations include a fully fledged underwriting platform staffed by experienced underwriters, managers and support staff. The London platform was established in 2006 to expand the Group's operations.

## DUBAI
3 Staff

Located in the Dubai International Financial Centre and led by two experienced insurance executives, the focus in Dubai is on marketing the Group's insurance products to clients in the Middle East.




## Business lines Expertise Base Ⓑ Bermuda Ⓛ London

### ❶ ENERGY

Offshore Gulf of Mexico
Ⓑ Ⓛ

Energy of Shore Worldwide
Ⓑ Ⓛ

Energy on Shore Worldwide
Ⓛ

Energy Reinsurance
Ⓑ

Construction Onshore/Offshore
Ⓑ Ⓛ

### ❷ AVIATION

Aviation 52 & 52B
Ⓑ Ⓛ

Aviation Reinsurance
Ⓑ

Aviation Contingent Hull
Ⓑ Ⓛ

Aviation Hull War
Ⓑ Ⓛ

### ❸ MARINE

Marine Hull
Ⓑ Ⓛ

Marine Hull War
Ⓑ Ⓛ

Marine Builder's Risk
Ⓑ Ⓛ

Marine Reinsurance
Ⓑ

Marine Yacht
Ⓛ

Mortgagee's Interest
Ⓛ

Mortgagee's Additional Perils
Ⓛ

Marine P&I
Ⓑ

### ❹ PROPERTY

Property Reinsurance
Ⓑ

Property Direct and Facultative
Ⓑ Ⓛ

Catastrophe Reinsurance
Ⓑ Ⓛ

Property Nuclear Pool
Ⓑ

Terrorism & Political Violence
Ⓑ Ⓛ

# Statement from Martin Thomas Non-Executive Chairman

In 2008 Lancashire was tested on both sides of the balance sheet, and passed with flying colours. Despite exposure to Hurricane Ike, the third most costly wind storm in U.S. history, and experiencing the worst financial crisis since the Great Depression, we have delivered a profit after tax of $97.5 million or $0.55 per common share and growth in fully converted book value per share plus dividends of 7.5 per cent.

The excellent results in this report have been achieved by sticking faithfully to our stated objectives: disciplined underwriting, minimised investment risk, and managing our capital through the cycle.

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## Underwriting results

In the first quarter of 2008 we said we expected subsequent quarters to experience premium reductions. A growing number of deals placed in the market did not meet our requirements. In particular, Lancashire's underwriters were highly selective when binding catastrophe-exposed deals. Consequently, Lancashire's gross and net exposure to U.S. windstorm risk was materially lower heading into the 2008 hurricane season than it was in 2007.

In 2008 we produced an underwriting profit of $132.2 million by sticking to our area of expertise which is in specialty direct short-tailed lines within the property, energy, marine and aviation segments. Despite softening rates we did not diversify into other classes of business.

Our Ike loss number is proof of the merits of being nimble through changing market conditions. Nevertheless, we will not rest on our laurels.

### Investments

In 2008 we achieved a positive 3.1 per cent total return on our investment portfolio in spite of the extraordinary turmoil in the financial markets. Lancashire's highly conservative investment approach has paid off; we have preserved liquidity and limited downside risk. This approach has clearly served us well and our investment strategy will remain very defensive for the foreseeable future.

### Capital management

In line with our active capital management strategy, and following the strategic dividend and share repurchase programme announced in 2007, in April 2008 the Board authorised an additional $100.0 million share repurchase programme. Under this programme, between April and August 2008, we repurchased 9,433,168 common shares at prices significantly below book value, resulting in immediately accretive value to shareholders. When Hurricane Gustav struck in August 2008, we suspended the repurchase programme.

In 2007 and 2008 we returned a total of $397.3 million to our shareholders via share repurchases and dividends.

We ended 2008 with a very strong balance sheet. In 2009 we intend to continue to pursue an active capital management strategy through the market cycle. 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.

### Cycle management

Our over-riding goal remains the same: to generate a superior risk-adjusted return over time. In 2009 it is likely that premium rates and conditions in our core products will continue to harden and we expect our goal will be best achieved through organic growth rather than strategic acquisitions. At the same time we intend to maintain our relatively lean operational base, backed by a sophisticated information technology platform and, above all, retain a strong focus on underwriting discipline and integrity.

Our risk management practices in particular are constantly under review. We intend to learn the lessons from Ike and the financial crisis. We will look at ways to earn an even better risk-adjusted return on our capital.

### Moving up

We have now completed three full years of trading and, with the publication of these results, are eligible to apply for the admission of the Company to the Official List and the admission of the Company's common shares to trading on the main market of the London Stock Exchange ("Admission").

We consider that the continued growth of the Group would be best achieved by moving up to the Official List. The Group will be better placed on Admission to achieve improved liquidity and visibility, especially given that it is likely to qualify for inclusion in the FTSE 250 index.

### The outlook

The world changed dramatically in 2008 and the insurance industry with it. There is likely to be more bad news for the world economy for some time to come and, while we will continue to be vigilant as events unfold throughout the year, there can be no assurance that we have or will identify and avoid all emerging risks and hidden dangers that could adversely impact our ability to achieve our business objectives.

It remains unclear to what extent the insurance industry has been reshaped by the erosion of capital caused by the 2008 hurricane and investment losses. In the short term there has been a significant estimated reduction in capacity and a hardening in rates across most lines of business the Group writes.

We are optimistic that 2009 will be a good year of trading for the Group.

### In conclusion

Richard Brindle, his executive team and all our staff deserve credit for executing Lancashire's business plan professionally and with discipline against a backdrop of unprecedented events.

**Martin Thomas**
Non-Executive Chairman

# Business review

### Business overview

Lancashire is a provider of insurance and reinsurance products on a global basis. It focuses predominantly on property specialty insurance. Lancashire writes risks within the property, energy, marine and aviation segments of the market and has a group rating from A.M. Best of A minus (excellent).

Lancashire has produced a compound annual return on equity since inception of 17.7 per cent.

In 2008, the percentage of Lancashire's business written in the four different lines by gross premium volume was as follows:

- Property 47.5 per cent
- Energy 29.0 per cent
- Marine 12.3 per cent
- Aviation 11.2 per cent

### Financial highlights for the twelve months to 31 December 2008:

- Fully converted book value per share of $6.86 at 31 December 2008, compared to $6.38 at 31 December 2007, an increase of 7.5 per cent;
- Gross written premiums of $638.1 million. Net written premiums of $574.7 million;
- Loss ratio of 61.8 per cent and a combined ratio of 86.3 per cent;
- Total investment return of 3.1 per cent including net investment income, realised gains and losses, impairments, and change in unrealised gains and losses;
- Net operating profit of $119.4 million, or $0.64 diluted operating earnings per share; and
- Net profit after tax of $97.5 million, or $0.53 diluted earnings per share.

### Dividend Policy

Lancashire approved the following dividend policy in February 2009.

"Lancashire intends to maintain a strong balance sheet at all times, while generating an attractive risk-adjusted total return for shareholders. We will actively manage capital to achieve those aims. Capital management is expected to include the payment of a sustainable annual dividend, supplemented by special dividends from time to time. Dividends will be linked to past performance and future prospects. Under most scenarios, the annual dividend is not expected to reduce from one year to the next. Special dividends are expected to vary substantially in size and in timing."

### Business structure

Lancashire has five wholly owned subsidiaries: Lancashire Insurance Company Limited ("LICL"), Lancashire Insurance Holdings (UK) Limited ("LIHL"), Lancashire Insurance Marketing Services Limited ("LIMSL"), Lancashire Insurance Services Limited ("LISL") and Lancashire Marketing Services (Middle East) Limited ("LMEL"). LIHL is a holding company for a wholly owned operating subsidiary, Lancashire Insurance Company (UK) Limited ("LUK").

The main operating companies of the Group are LICL and LUK, which both provide insurance and reinsurance products to their customers, with an emphasis on the property, energy, marine and aviation lines of business in Bermuda and London, respectively.

LMEL, LIMSL and LISL provide services to Group companies. LMEL undertakes insurance intermediation activities on behalf of LICL and LUK, whilst LIMSL provides insurance mediation and support services. LISL provides support services to LIMSL and LUK.

**7.5 per cent**

Return on equity for 2008

**$97.5 million**

Net profit for 2008

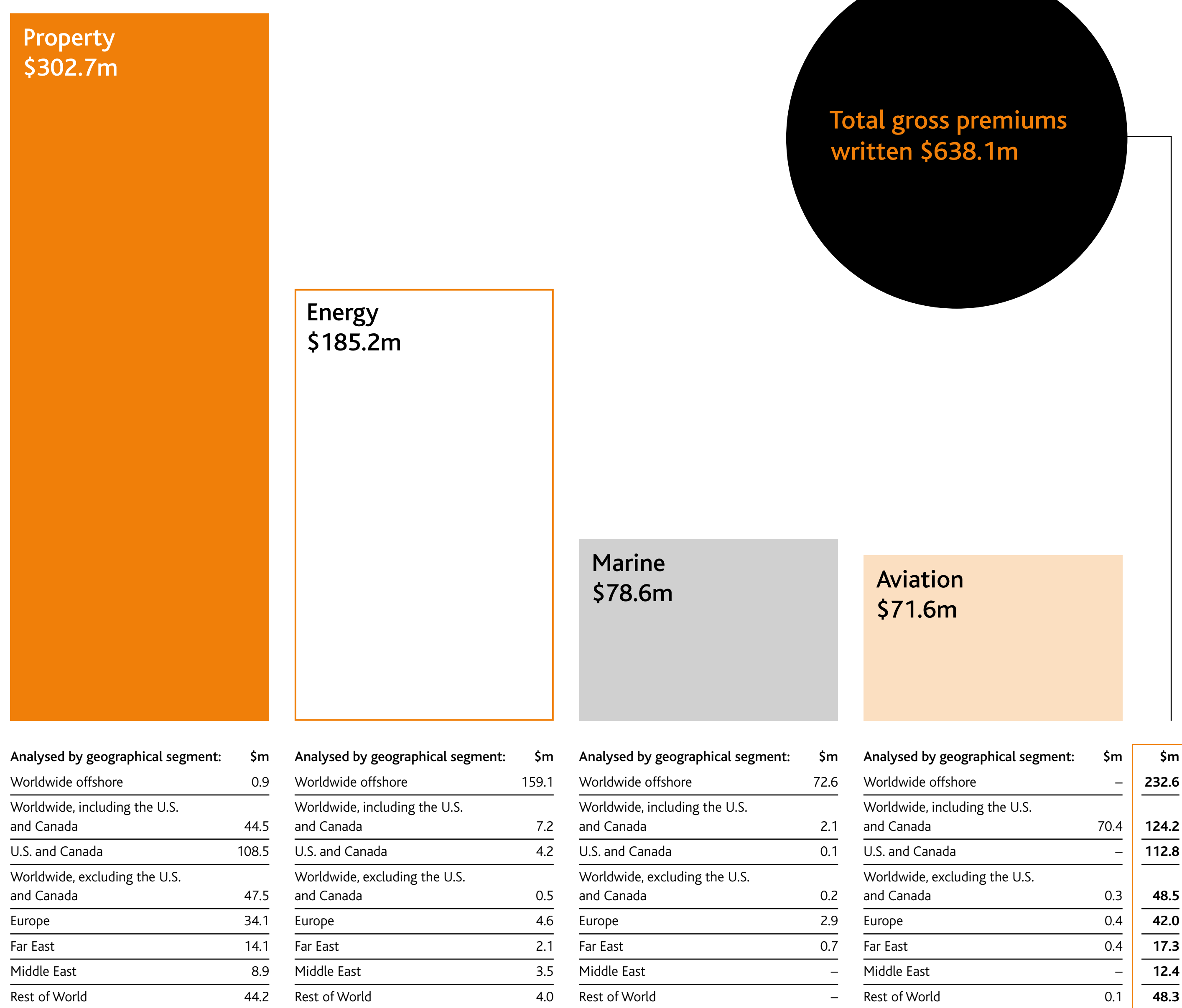
**86.3 per cent**

Combined ratio for 2008

## Revenue and expense by business segment

for the year ended 31 December 2008

### Gross premiums written



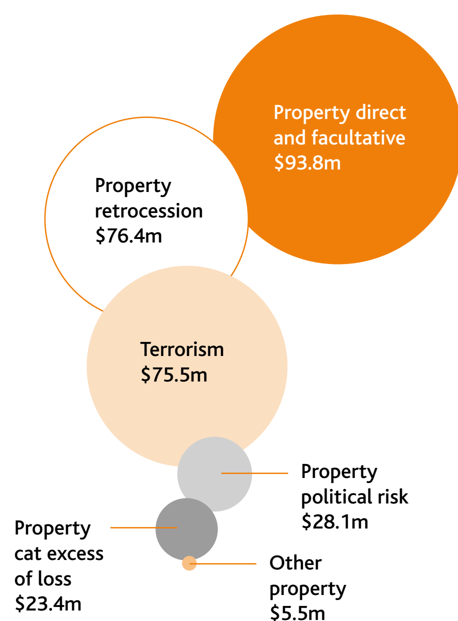

| Analysed by geographical segment: | Property $m | Energy $m | Marine $m | Aviation $m | Total $m |
|---|---|---|---|---|---|
| Worldwide offshore | 0.9 | 159.1 | 72.6 | – | **232.6** |
| Worldwide, including the U.S. and Canada | 44.5 | 7.2 | 2.1 | 70.4 | **124.2** |
| U.S. and Canada | 108.5 | 4.2 | 0.1 | – | **112.8** |
| Worldwide, excluding the U.S. and Canada | 47.5 | 0.5 | 0.2 | 0.3 | **48.5** |
| Europe | 34.1 | 4.6 | 2.9 | 0.4 | **42.0** |
| Far East | 14.1 | 2.1 | 0.7 | 0.4 | **17.3** |
| Middle East | 8.9 | 3.5 | – | – | **12.4** |
| Rest of World | 44.2 | 4.0 | – | 0.1 | **48.3** |

# Business review *continued*

## Property

HIGHLIGHTS

- Gross premium of $302.7m (2007 – $309.3m)
- Loss ratio of 37.1% (2007 – 14.0%)
- Net underwriting income of $137.2m (2007 – $194.3m)
- Performed very well despite high incidence of large catastrophe and risk losses in 2008

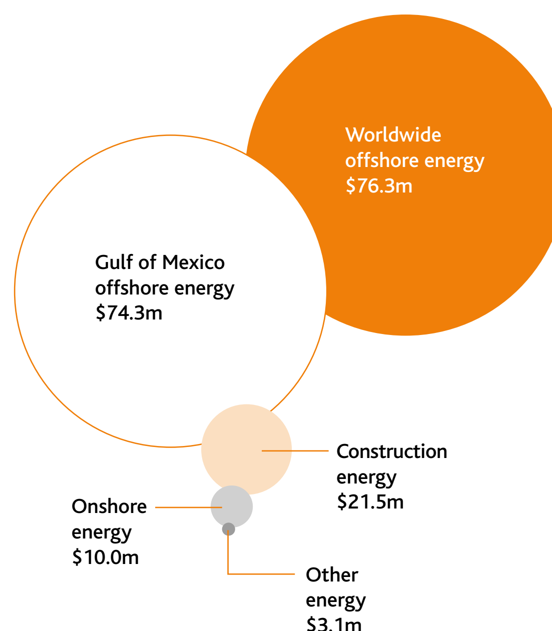



| Gross premiums written | 2008 $m | 2007 $m |
|---|---|---|
| Property direct and facultative | 93.8 | 122.8 |
| Property retrocession | 76.4 | 88.5 |
| Terrorism | 75.5 | 56.6 |
| Property political risk | 28.1 | 16.9 |
| Property cat excess of loss | 23.4 | 19.3 |
| Other property | 5.5 | 5.2 |
| **Total** | **302.7** | **309.3** |

## Energy

HIGHLIGHTS

- Gross premium of $185.2m (2007 – $282.7m)
- Loss ratio of 119.5% (2007 – 33.2%)
- Net underwriting (loss)income of ($68.6m) (2007 – $116.7m)
- Lancashire is one of the leading energy writers in the world
- As market softened in 2008, reduced exposure significantly
- Respectable performance given 2008 saw one of the largest natural catastrophes in recent times

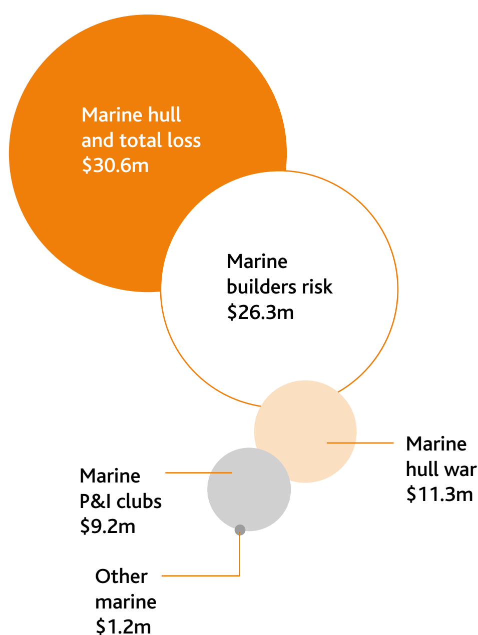



| Gross premiums written | 2008 $m | 2007 $m |
|---|---|---|
| Worldwide offshore energy | 76.3 | 72.7 |
| Gulf of Mexico offshore energy | 74.3 | 157.5 |
| Construction energy | 21.5 | 24.5 |
| Onshore energy | 10.0 | 25.3 |
| Other energy | 3.1 | 2.7 |
| **Total** | **185.2** | **282.7** |

## Marine

HIGHLIGHTS

- Gross premium of $78.6m (2007 – $76.9m)
- Loss ratio of 54.0% (2007 – 55.1%)
- Net underwriting income of $13.1m (2007 – $16.1m)
- The Lancashire marine book continues to be highly profitable
- Focus remains on finding attractive niche areas whilst retaining overall caution for the sector as a whole

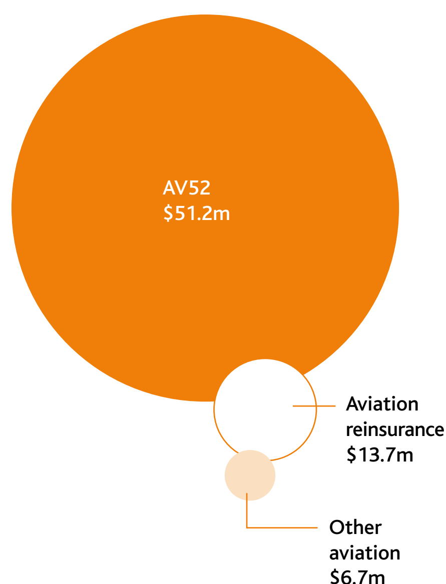



| Gross premiums written | 2008 $m | 2007 $m |
|---|---|---|
| Marine hull and total loss | 30.6 | 29.4 |
| Marine builders risk | 26.3 | 22.3 |
| Marine hull war | 11.3 | 11.4 |
| Marine P&I clubs | 9.2 | 9.4 |
| Marine excess of loss | – | 4.4 |
| Other marine | 1.2 | – |
| **Total** | **78.6** | **76.9** |

## Aviation

HIGHLIGHTS

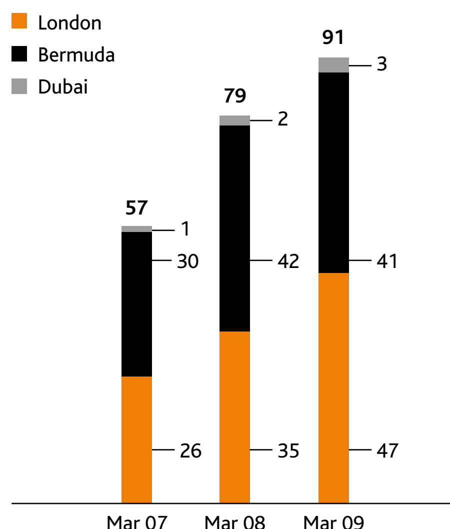
- Gross premium of $71.6m (2007 – $84.2m)
- Loss ratio of 10.9% (2007 – 5.1%)
- Net underwriting income of $50.5m (2007 – $61.3m)
- The Lancashire aviation book continues to be highly profitable
- Have now achieved lead status on most accounts



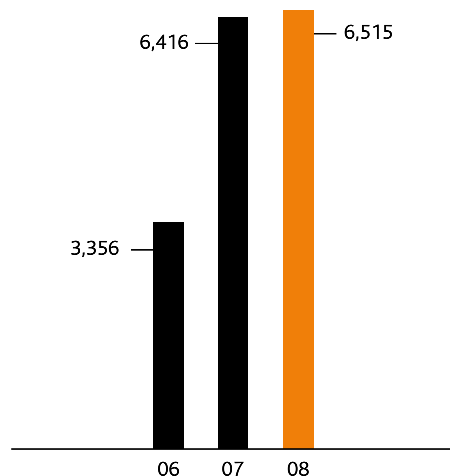

| Gross premiums written | 2008 $m | 2007 $m |
|---|---|---|
| AV52 | 51.2 | 63.1 |
| Aviation reinsurance | 13.7 | 10.7 |
| Other aviation | 6.7 | 10.4 |
| **Total** | **71.6** | **84.2** |

# Business review *continued*

## EMPLOYEE NUMBERS




## GROWTH IN SUBMISSIONS




### Locations

Lancashire operates from three offices and insures (or reinsures) risks located all over the world. Bermuda and London are underwriting offices, and the Dubai office is a marketing base for the Middle East region. These three offices provide a good balance between group underwriting control, access to business and low operating costs.

The UK and Bermuda underwriting centres are both authorised to write every class of business in our business plan. Our London office primarily writes the following types of business: property direct and facultative, terrorism and political risk, energy, marine insurance classes where there is higher level of interaction with brokers, and AV52 aviation third party. In the Bermuda office there is a balance between specialty insurance and treaty reinsurance including a larger proportion of business exposed to natural catastrophes.

### Distribution

It is difficult to overstate the importance of broker and customer relationships in achieving effective distribution of our products. Almost all of our business is transacted through brokers and we work hard to foster close working relationships. 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. We believe we meet all of these requirements.

### People

All Lancashire staff add tremendous value to the organisation and are encouraged to stretch themselves and strive for high performance standards. Expectations are high and our people work quickly, efficiently and decisively in order to capitalise on changing conditions.

Staff are highly aligned to the company goals and this is reflected in the results of the 2008 employee opinion survey.

- Over 90 per cent of respondents' understand how their job contributes to the overall success of the company
- Over 80 per cent of respondents believe that the majority of employees at Lancashire are committed to making it a successful business
- Almost 80 per cent of respondents believe that "if the company does well, I will do well"

In return Lancashire staff are offered competitive compensation but more importantly they are exposed to a wide breadth of responsibility and the opportunity for continuous learning.

The following are quotes from staff when asked "What do you like most about Lancashire?"

"When I first joined I felt it was an extremely close knit environment with a family feel, which makes the office an easy place to work in."

"1. The people. 2. The fact that hard work is recognised and rewarded. 3. Variety in my work."

"Good people, high standards, trying to do the right thing."

"The feeling that all staff are committed and pull together, especially within the team I work."

"A lot of great people who want the best for each other and the company."

## Investments

Our overriding investment goal has remained unchanged from Day 1: "Don't lose your money".

This was particularly difficult to do in 2008 – something that is evident from the unprecedented investment losses suffered by the insurance industry – but we are very proud to say that we achieved our goal. In fact, we produced a total investment return of 3.1 per cent.

Our tolerance to risk on investments is very low by industry standards. Our primary investment objectives are to preserve capital and provide adequate liquidity to support the Group's payment of claims. A secondary objective is to maximise total risk-adjusted return, with low volatility.

Lancashire has three investment portfolios: "core", "core plus" and "surplus". The Group's investment guidelines regulate the composition of each portfolio. The "core" portfolio contains at least enough funds required to meet cash flow needs following an extreme event plus loss reserves. Assets in excess of those required to settle potential insurance liabilities in an extreme event may be held in the "core" portfolio, the "core plus" portfolio or in the "surplus" portfolio.

Our portfolio mix illustrates our philosophy. Fixed income investments and cash account for 99.7 per cent of total invested assets. Duration is short at 1.8 years and average credit quality is high at AA+.

As is the case in all areas of Lancashire, we try to be nimble in our investment strategy. We apply common sense as much as anything else, often disagreeing with conventional wisdom on the state of the economy. We do not place much credence on a 'black box' approach to investment strategy.

That said, investing is inherently unpredictable; not all of our decisions have been right and sometimes the timing has been wrong, but some of the larger decisions have worked out well. Back in the second half of 2007 we concluded that the investment markets were going to experience tough times. Since then we have made several key defensive decisions to address credit risk and interest rate risk, while maintaining an acceptable yield albeit low by historical standards:

- Q4 2007: Exited non-agency structured product classes including CMBS, RMBS and ABS classes
- Q1 2008: Significantly reduced exposure to financial sector corporate bonds, including selling all Lehman Brothers holdings. Increased weighting in Treasuries

| As at 31 December 2008 | $m | % | $m | % | $m | % | $m | % |
|---|---|---|---|---|---|---|---|---|
| | Core | | Core plus | | Surplus | | Total | |
| **Available for sale** | | | | | | | | |
| – Short-term investments | 101.5 | 6.4 | 9.9 | 0.6 | 52.2 | 3.3 | 163.6 | 10.3 |
| – U.S. treasuries | 148.3 | 9.3 | 15.8 | 1.0 | 27.6 | 1.7 | 191.7 | 12.0 |
| – Other government bonds | 27.7 | 1.7 | 11.4 | 0.7 | 15.0 | 0.9 | 54.1 | 3.3 |
| – U.S. government agency debt | 39.5 | 2.5 | 15.5 | 1.0 | 59.5 | 3.7 | 114.5 | 7.2 |
| – U.S. government agency mortgage backed securities | 180.9 | 11.3 | 82.2 | 5.1 | 351.3 | 22.0 | 614.4 | 38.4 |
| – Corporate bonds | 138.3 | 8.6 | 52.0 | 3.2 | 113.2 | 7.1 | 303.5 | 18.9 |
| – Corporate bonds – FDIC guaranteed[1] | 108.8 | 6.8 | 14.6 | 0.9 | 30.0 | 1.9 | 153.4 | 9.6 |
| – Convertible debt securities | – | – | – | – | 0.2 | – | 0.2 | – |
| **Available for sale** | **745.0** | **46.6** | **201.4** | **12.5** | **649.0** | **40.6** | **1,595.4** | **99.7** |
| **At fair value through profit and loss** | | | | | | | | |
| – Convertible debt securities | – | – | – | – | 4.0 | 0.3 | 4.0 | 0.3 |
| **Total fixed income securities** | **745.0** | **46.6** | **201.4** | **12.5** | **653.0** | **40.9** | **1,599.4** | **100.0** |

(1) FDIC guaranteed corporate bonds are protected by the Federal Deposit Insurance Corporation, an independent agency of the United States government.

# Business review *continued*

- Q2 2008: Remained defensive, including increasing allocation to cash to 39 per cent of total assets
- Q3 2008: Continued to reduce equity holdings from 5 per cent to less than 1 per cent by December 2008
- Q4 2008: Reduced weighting in Treasuries and increased weighting to FDIC backed corporate debt, Agency debt and Agency MBS.

We have no plans to change our investment philosophy in the foreseeable future. We will continue to monitor the macro environment very closely, and at this time we are not optimistic about the ability of the world economy to rebound in 2009. Until we have a high degree of confidence that the worst is well and truly past we are more likely to take defensive investment actions than not.

## Cash flow and liquidity

### Cash flow

Lancashire's cash inflows are primarily derived from premiums received, from losses recovered under reinsurance contracts and from net investment returns. Excess funds are invested in our investment portfolio, which consists of high quality, liquid fixed income securities of short duration.

Other cash inflows result from the sale and redemption of investments and underwriting commissions.

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

### Cash flows for 2008

Following a strong 2007, net cash flow from operating activities was again positive in 2008.

### Cash flows from operating activities

A net positive cash inflow arose from operations during the year of $360.7 million (2007 – $521.5 million). Positive cash flow from operations was achieved despite the Group's exposure to losses from Hurricanes Ike and Gustav. Due to the complexity of Ike claims in particular and the associated loss adjustments, a relatively low number of Ike claims had been settled by 31 December 2008. It is expected, however, that the majority of outstanding claims from the 2008 U.S. wind storm season will be settled in 2009.

### Cash flows from investing

There was a net cash outflow from investing activities in 2008 of $358.6 million (2007 – $89.6 million) primarily as a result of the net purchase of fixed income securities of $479.8 million. This was partially offset by inflows of interest and dividends received of $82.1 million (2007 – $83.5 million) and proceeds of $34.8 million were received from the sale of equities (2007 – $6.0 million).

During 2008, the investment portfolio yielded lower cash returns than 2007 as a result of the lower interest rate environment. As higher yielding securities matured or were sold, the proceeds were reinvested in securities with coupon payments at lower prevailing market rates. However, the Group still managed to realise a positive cash flow benefit as the underlying market value of the investments increased, leading to higher realised cash gains from investment sales.

### Cash flows from financing activities

Financing activities resulted in a net outflow of $316.5 million as a result of a strategic dividend paid in January of $238.2 million, shares repurchased during the year of $68.3 million and $10.0 million of interest payments made to holders of the Company's long-term debt.

### Liquidity

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

Liquid securities will be maintained at sufficient levels to more than meet expenses (including unanticipated claims payments). It is only once safety, liquidity, and investment income requirements are satisfied, that additional growth in the investment portfolio may be pursued.

More detail on the practical application of this approach to liquidity is set out in the discussion of investment performance on page 22.

## Financial performance

2008 was a year of financial market turmoil and higher than normal frequency and severity of industry risk losses and natural catastrophe losses, including Hurricane Ike (which was the third costliest hurricane to make landfall in the United States). Despite this Lancashire has produced an excellent return for shareholders. While losses were incurred in respect of Hurricane Ike, they were lower than Lancashire's market share of premiums would have indicated.

Financial highlights for the twelve months to 31 December 2008:

- Fully converted book value per share of $6.86 at 31 December 2008, compared to $6.38 at 31 December 2008, an increase of 7.5 per cent. Compound annual return on equity since inception of 17.7 per cent;
- Gross written premiums of $638.1 million. Net written premiums of $574.7 million;
- Loss ratio of 61.8 per cent and a combined ratio of 86.3 per cent;
- Total investment return of 3.1 per cent including net investment income, realised gains and losses, impairments, and unrealised gains and losses;
- Net operating profit of $119.4 million, or $0.64 diluted operating earnings per share; and
- Net profit after tax of $97.5 million, or $0.53 diluted earnings per share.

### Underwriting results

In 2008, gross written premiums decreased by $115.0 million, or 15.3 per cent, compared to 2007.

The reduction in written premiums was because many lines experienced lower premium rates than in previous periods, and a corresponding greater proportion of submissions was declined. This was particularly evidenced in the energy lines, where pricing and risk profile remained relatively unattractive throughout most of the year. However, there was evidence of rate reductions reversing during the fourth quarter of 2008 and renewal premiums increasing. Lancashire's Renewal Price Index ("RPI") is calculated on a per contract basis, and takes into account both pricing and terms and conditions. The following RPIs are expressed as a percentage of pricing achieved on similar contracts written in 2007.

| Class | Q1 2008 | Q2 2008 | Q3 2008 | Q4 2008 |
|---|---|---|---|---|
| Property | 85% | 85% | 90% | 100% |
| Energy | 81% | 82% | 92% | 108% |
| Marine | 97% | 95% | 100% | 99% |
| Aviation | 92% | 87% | 92% | 96% |
| Combined | 87% | 85% | 92% | 101% |

The overall RPI for the year was 91 per cent.

The Group's ceded premium reduced from $86.3 million for 2007 to $63.4 million for 2008. Contributing factors were the reduction in the amount of Energy Gulf of Mexico business written (and therefore the quota share cession thereon) and a reduction in the purchase of other protection against natural catastrophes, including the commutation of the quota share cession to the Lancashire sponsored energy sidecar, Sirocco Reinsurance Limited ("Sirocco Re"), at the end of 2007. This reduction was partially offset by an increase in reinsurance purchased to mitigate losses from events other than natural disasters, most of which was purchased in the first quarter of 2008.

Net written premium decreased 13.8 per cent for 2008 chiefly due to lower gross written premiums, offset somewhat by lower purchases of reinsurance.

Net earned premiums were 105.7 per cent, as a proportion of net written premiums, as compared to 91.7 per cent for 2007. This increase indicates that, after reaching its third year of operations, Lancashire has built a mature portfolio of business, whereas in 2007 the portfolio was still in a growth phase.

The policy acquisition cost ratio increased by 3.9 percentage points, from 12.5 per cent in 2007 to 16.4 per cent in 2008. This was partially due to a changing business mix and a softening market, but it was driven significantly by the commutation (effective as at 31 December 2007) of the business ceded to Sirocco Re, the energy sidecar sponsored by Lancashire in 2006 and 2007. A profit commission received from Sirocco Re of $7.8 million was recognised in net acquisition costs in 2007. Without the impact of this commutation, the policy acquisition cost ratio would have been 13.8 per cent for 2007 as compared to 16.4 per cent for 2008.

The net loss ratio of 61.8 per cent for the twelve months to 31 December 2008 is largely driven by the third quarter losses associated with Hurricane Ike. The combined net negative impact of Hurricanes Gustav and Ike was $152.9 million. Loss experience for the year was very mixed quarter on quarter. The first quarter was a "normal" quarter for losses, with the second quarter producing more than average frequency and severity of risk losses. The third quarter produced some significant hurricanes, including Hurricane Ike. The fourth quarter, by contrast, was exceptionally quiet and fewer losses than might normally be expected were reported. Net prior year reserve releases were $28.6 million in 2008.

# Business review *continued*

**Investment performance**
Net investment income was $59.5 million in the twelve months to 31 December 2008, a decrease of 24.1 per cent over 2007. The decrease in net investment income was primarily due to lower yields on the Group's bond portfolio. The lower yields were driven to a large extent by reductions in U.S. interest rates throughout 2008, together with the impact of executing the tactical decision to exit certain higher yielding fixed income classes, including all non-agency structured products, in the fourth quarter of 2007.

Total investment return, including net investment income, net realised gains and losses and net change in unrealised gains and losses, was a positive $55.1 million for the year. Given the continued volatility of equity markets, the Company's modest allocation to equities was nearly all liquidated in the fourth quarter. The fixed income portfolio performed well in relative terms due to the defensive position in government backed securities, and being underweight in corporate bonds. In the uncertain markets of 2008, the strategy also included holding an overweight position in cash and maintaining a high quality, short duration bond portfolio with underweight allocations to the financial sector securities that do not directly benefit from government support.

At 31 December 2008 the fixed income portfolio plus managed cash had a duration of 1.8 years, a credit quality of AA+ and a market yield of 3.1 per cent. Investment assets were comprised of 80.3 per cent fixed income, 0.3 per cent equities and 19.4 per cent cash. Lancashire did not invest in hedge funds or other alternative investments in 2008 and has no plans to make investments in hedge funds or other alternative investments at this time.

## Capital management

**Capital**
As at 31 December 2008, total capital was $1.404 billion, comprising shareholders' equity of $1.273 billion and $130.8 million of long-term debt.

Lancashire has a standard letter of credit facility in the amount of $200.0 million with a $75.0 million loan sub-limit available for general corporate purposes. This $75.0 million loan facility has not been drawn down upon. There are no off-balance sheet forms of capital. Leverage was 9.3 per cent.

As stated earlier, Lancashire aims to maintain a strong balance sheet at all times and this was the case throughout 2008. An appropriate level and mix of capital must be maintained to support the Group's underwriting. The primary sources of funds are the collection of premium and investment income. The primary outflows or uses are payment of losses and expenses, including reinsurance purchased, plus the servicing of debt and other financing obligations.

Throughout 2008 management and the Board reviewed the level and composition of capital on a regular basis with a view to:

- maintaining sufficient capital to take advantage of underwriting opportunities and to meet obligations to policyholders;
- maximising the return to shareholders within pre-determined risk tolerances; and
- maintaining adequate financial strength ratings and meeting regulatory requirements.

Capital is therefore raised or returned as appropriate. Capital raising can include debt or equity. Returns to shareholders 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.

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

- the underwriting opportunities: matching capital to the underwriting opportunities ahead;
- the level of various risk factors which the Group currently has, and what the Group anticipates having in the short to medium term;
- the ability to raise capital or debt from the financial markets; and
- the stage of the cycle.

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

$1.404 billion

Total capital at 31 December 2008

$360.7 million

Net cash flow from operating activities in 2008

risk categories. Management increasingly uses these approaches in decision making. The operating companies also conduct capital requirement assessments under internal measures and in compliance with local regulatory requirements.

In 2008, BLAST, Lancashire's economic capital model, was used to provide management and the Board of Directors with information on risk and return to assist with business decisions. The model was also used to help determine the appropriate level of capital to carry.

The composition of capital is also driven by management's appetite for leverage. In appropriate circumstances, management would be willing to modestly increase leverage somewhat. An increase in leverage would more likely take place after a market hardening event, but this may not necessarily be the case, and is entirely dependant on the availability and price of debt and the Group's ability to raise finance in the capital markets. Maintaining a strong balance sheet will be the overriding factor in all capital management decisions.

**Liquidity**
Lancashire is exposed if proceeds from financial assets are not sufficient to fund obligations arising from its insurance contracts and other areas. In the period since inception, operating cash flow has been positive. In 2006 net cash flow from operating activities was $277.2 million. In 2007 it was $521.5 million and in 2008 it was $360.7 million. The significant positive cash flow in 2006 and 2007 is partly a function of the low number of catastrophic loss events in those years. In 2008, there was still significant positive cash flow despite the occurrence of Hurricane Ike. The majority of claims from Hurricane Ike are expected to settle in 2009. Lancashire has more than adequate liquid resources available to fund these claims. Overall, operating cash flows are expected to remain positive in 2009.

Lancashire does not currently pay an ordinary dividend but paid a strategic dividend of $239.1 million on 25 January 2008 and returned a further $100.2 million to shareholders via a share repurchase during 2007. In 2008 a further $58.0 million of shares were repurchased. Lancashire may introduce an ordinary dividend during 2009.

The Group manages its liquidity risks via its investment strategy to hold high quality, highly liquid securities, sufficient to meet its insurance liabilities. 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.

### Enterprise risk management
Lancashire has a comprehensive Enterprise Risk Management ("ERM") program. The Board sets the overall Group risk profile and appetite and is responsible for monitoring risk at Group level. Day-to-day ERM activities are coordinated by Lancashire's Chief Risk Officer ("CRO").

Risk Committees have been formed at the operating entity level. Each Risk Committee operates under terms of reference that details its scope and operation. The Risk Committees define tolerance levels over categories of risk for the operating entities. This includes the level of capital the operating entities are willing to expose to certain risks.

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

**BLAST**
Lancashire has developed a sophisticated economic capital model called BLAST, which is an integral part of Lancashire's ERM program. BLAST provides management with information on risk and return that can assist with business decisions.

It is primarily a stochastic model, which encompasses insurance risk, market risk, credit risk and other general risks including operational risk and requires the input of a large number of parameters and data.

BLAST helps determine the level of capital required across the Group to meet the combined risk from a wide range of categories. BLAST is a useful tool, the results of which are incorporated into the day-to-day decision making and assists management in monitoring its risk adjusted returns.

**Insurance risk**
Lancashire underwrites contracts that transfer insurance risk. Lancashire underwrites worldwide short-tail insurance and reinsurance risks, including risks exposed to natural and manmade 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.

# Business review *continued*

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, the Reinsurance Security Committee assesses reinsurers as appropriate security based on their financial strength, ratings and other factors. Lancashire monitors the credit-worthiness of its reinsurers on an ongoing basis.

Lancashire regularly reviews its exposure to natural and man-made catastrophic events and under the right set of circumstances will purchase reinsurance in order to reduce its exposure to a catastrophic event.

**Market risk**
Investment guidelines are established by the Investment Committee of the Board to set parameters within which Lancashire's external investment managers must operate and compliance with these guidelines is monitored on a monthly basis. Important parameters include guidelines on permissible assets, duration ranges, credit quality and maturity.

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 the Group'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; and
- Regular review of output from Lancashire's economic capital model, BLAST, to judge up-to-date profitability of classes and sectors.

**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 has established asset allocation and maturity parameters within the investment guidelines such that the intention is to have the majority of Lancashire's investments in high quality assets, which could be converted into cash promptly and at minimal expense. The Group monitors market changes and outlooks and re-allocates assets as deemed necessary.

**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. Lancashire aims to limit its exposure to any significant credit concentration risk on its investment portfolio.

Lancashire is exposed to credit risk in the event of non-performance of

counter-parties to derivative contracts. 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.

Lancashire also periodically monitors the creditworthiness of brokers pursuant to its broker vetting procedures.

**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 periodically. Lancashire's internal audit function assesses the key risk areas on an annual basis and performs periodic 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 periodic basis.

Lancashire's operations are regulated in each of the jurisdictions it does business. Changes in local regulatory frameworks or taxation regulations could impact the way the local entities and/or the Group conducts business. Therefore, Lancashire regularly monitors for changes in law and regulation that could impact its business.

Lancashire is in a mature trading position having had over three years to develop broker and client relationships and has established an enviable market reputation. Lancashire is vulnerable to adverse market perception since it operates in an industry where customer integrity, trust and confidence are paramount. In addition, any negative publicity (whether well founded or not) associated with the business or operations of the Group could result in a loss of clients and/or business. Lancashire therefore actively assesses its relationships with brokers to identify strengths and also assesses for improvements.

**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. The Group addresses this risk by a continual rigorous assessment of business goals. The BLAST model is increasingly an integral part of the review of profitability and capital utilisation. Lancashire's Board has established a rolling three-year strategy that is reviewed at least annually. Business performance within the context of the overall strategy is reviewed with the Board on a quarterly basis. Market or economic events may lead to a need to re-assess strategy more frequently.

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

Lancashire's Board has established a rolling three-year strategy that is reviewed at least annually. Business performance within the context of the overall strategy is reviewed with the Board on a quarterly basis.

# Business review *continued*

## Corporate responsibility

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

### 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.

### Employees

At March 2009, Lancashire had 91 employees; 47 in London, 41 in Bermuda and 3 in Dubai.

Lancashire is an equal opportunity employer, and does not tolerate unfair discrimination of any kind in any aspect of employment, including recruitment, training, promotion, compensation, benefits, career development and advancement. 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 and other policies are available to all employees in the staff handbook, which is on the Group's intranet.

We take staff retention seriously as we think that staff who understand our business are best placed to ensure Lancashire's continued success. We also believe that as many employees as possible should become shareholders in Lancashire. 3.95 per cent of our fully diluted share count is represented by staff through shares or options. All Lancashire staff with greater than a year's service are owners of Lancashire's shares through actual share holdings or through warrants, options or restricted stock. This creates great team spirit and has been an important part of Lancashire's success to date.

### 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)) are subject to routine regulatory reviews, although no such reviews were conducted during 2008. 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 2009, LICL and LUK were eligible for surplus lines insurance and reinsurance in 44 and 42 U.S. jurisdictions respectively, but are not licensed insurers in any U.S. state or territory. For those U.S. states where LICL or LUK is not currently excess and surplus lines eligible, Lancashire, subject to compliance with applicable law and regulation, may write insurance on a direct procurement basis or take advantage of appropriate exemptions.

### Rating agencies

Lancashire enjoys a positive relationship with rating agencies. The Group has a financial strength rating of A minus (Excellent) with a stable outlook from A.M. Best. This rating is sufficient to allow the Group to trade successfully in all the major global insurance markets. It is also in discussion with Standard & Poor's (S&P) and Moody's with a view to obtaining satisfactory ratings from them in due course.

### Investor relations

In June 2008, Lancashire appointed a full-time Head of Investor Relations and Marketing who has been focusing on developing our relationship with investors, potential investors and analysts. A significant number of investor meetings in the UK and U.S. as well as Investor Days in New York and Boston, presenting to analysts, sales teams, investors and potential investors were held during the latter part of 2008.

Lancashire's shares are to be admitted to the Official List and to trading on the main market of the London Stock Exchange (the "Main Market") under the ticker symbol LRE.L on 16 March 2009.

### In the community

Lancashire set up the Lancashire Foundation, a Bermuda charitable trust in 2007 with the aim of creating a charitable trust for the benefit of charitable causes in Bermuda and elsewhere (the "Foundation"). The Foundation's trustee is an independent third party professional trust company

that makes donations following recommendations as made by the Company's Donations Committee consisting of Lancashire employees and independent members. Specific criteria have been set for the Foundation's charitable giving. These criteria include causes where Lancashire staff or independent Donations Committee members have a close relationship with those who operate the charity and therefore have the ability to monitor and influence outcomes.

In 2008 the Group supported The Sunshine League, The Family Centre and BASE (Bermuda Autism Support & Education Society) in Bermuda and, in recognition of the fact that a significant element of Lancashire's business is connected to insuring against natural catastrophes, the decision was taken to support Médecins Sans Frontières, a charity that the Foundation views as well equipped to provide immediate and lasting humanitarian aid to people directly affected by such catastrophes due to its international presence.

**Business environment and outlook**

Lancashire is in a mature trading position having had over three years to develop broker and client relationships. Across most of its classes it is able to access all the business that it wishes to review. In 2008 there were very substantial losses to the (re)insurance markets both from insured losses and balance sheet events including losses from declining investment markets. The outlook in the specialty insurance and reinsurance markets is that there will be a resultant general hardening of pricing and some improvements to terms and conditions in 2009; Lancashire supports this view. Early indications are that pricing and terms are meeting our expectations that there will be a broad-based improvement in pricing across most of the lines of business that the Group writes, as well as some areas of beneficial improvements in terms and conditions.

As primarily an insurance provider, the Group writes business over the course of the year and results are not driven by the strength of the 1 January renewal season. The Group does write a substantial part of its Property Retrocession book at 1 January, however, and pricing has been in line with expectations, with rate increases in the region of 20 per cent and some improvement in terms and conditions. The Group's next major line of business renewal period is March through June on its Energy Gulf of Mexico book. Current expectations are substantial rate increases with significant improvements in terms and conditions. The Group's Property Direct and Facultative book is written throughout the year. Rates in this line of business are beginning to improve and expectations are that rates will improve through the first quarter of 2009 and further throughout the year.

As rates in the insurance market improve, the converse is true for Lancashire's reinsurance program. Reinsurance rates are increasing and certain covers that the Group may previously have purchased, or had access to, may no longer be available or at increased cost.

While the turmoil in the investment markets continues, total investment returns are expected to remain lower than have historically been experienced. Lancashire has a conservative investment strategy, with the primary goal of maintaining capital.

The Group's aim is to provide shareholders with a risk-adjusted return on equity of 13 per cent in excess of a risk free rate over the insurance cycle. With the current pricing expectations for the Group's preferred lines of business, the outlook for 2009 is cautiously optimistic.

**Neil McConachie**
Chief Financial Officer
10 March 2009

Lancashire is in a mature trading position having had three years to develop broker and client relationships. Across most of its classes it is able to access all the business that it wishes to review.

# The board

## NON-EXECUTIVE DIRECTORS

**Martin Thomas (age 45)**
**Non-Executive Chairman**

Martin Thomas is a partner and board member of Altima Partners, LLP, a UK based hedge fund manager. Prior to this, he was an official of the Bank of England, most recently on secondment to the EU Commission where 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 prior to that, 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 in the law and regulation of financial services at Clifford Chance.

**Jens Juul (age 60)**
**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 chief executive officer of Scandinavian Reinsurance Company Limited until his retirement in 2002. He is an ARIAS-U.S. certified arbitrator and umpire.

**Ralf Oelssner (age 64)**
**Non-Executive Director and Senior Independent Non-Executive Director**

Ralf Oelssner was vice president of corporate insurance for Lufthansa German Airlines until 31 October 2007. In 1979, he was appointed director of 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 its foundation in May 1986 until dissolution of the company in March 2007. He is president of the German Risk Managers' Association. He holds an M.A. in Economics from Cologne University.

**Robert Spass (age 53)**
**Non-Executive Director**

Robert Spass is a founding partner of Union Square Partners, an investment firm he joined on 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 Universal American Financial Corp., Endurance Specialty Holdings, Ltd. and other privately held companies.

**William Spiegel (age 46)**
**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 boards of Catlin Group Limited, Financial Guaranty Insurance Co., MedPointe, Inc., Montpelier, and Scottish Re Group Limited.

**Barry Volpert (age 49)**
**Non-Executive Director**

Barry Volpert is co-founder, chairman and chief executive officer of Crestview Partners, LP a private equity firm. Prior to founding Crestview 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, including Oxbow Carbon LLC, FHC Health Systems, Inc. and Key Safety Systems Inc.

**John Bishop** **(age 63)**
**Non-Executive Director**

John Bishop was appointed to the Board on 19 March 2008. Mr Bishop is an actuary with broad experience in the insurance business. He has served on the boards of a number of insurance companies, including Sun Alliance Group and Eagle Star Group, both in an executive capacity and as a non-executive director. Mr Bishop has previously worked at the Euler Group on its managing board and as chairman and chief executive officer of Eagle Star Insurance Company Ltd, where he was responsible for the worldwide general insurance operations and, before that, as a managing director of Sun Alliance UK Insurance Company.

## EXECUTIVE DIRECTORS

**Richard Brindle** **(age 46)**
**Chief Executive Officer**

Richard Brindle was the driving force behind the establishment of Lancashire in late 2005 and serves as a member of the 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 38)**
**Deputy Chief Executive Officer**

Simon Burton joined Lancashire in March 2006 and leads the Bermuda subsidiary Lancashire Insurance Company Limited. He is also a member of the 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 held various roles within FSI, his most recent being president of the unit with responsibility for underwriting, operations and financial performance of FSI’s 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 36)**
**Chief Financial Officer**

Neil McConachie joined Lancashire in February 2006 and leads the finance functions of the Group and serves as a member of the 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 Re Holdings Ltd. Prior to joining Montpelier Re Holdings Ltd, Mr McConachie worked for PricewaterhouseCoopers in London and Bermuda and at Stockton Holdings Limited.

## COMPANY SECRETARY

**Greg Lunn**
**Group General Counsel**

Greg Lunn joined Lancashire in February 2006 and is responsible for all legal affairs as well as being Company Secretary. Before joining Lancashire in 2006, Mr Lunn spent almost nine 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 Financial Services and Markets Act 2000.

# Directors' report

## Overview of the Group

Lancashire is a Bermuda incorporated company with operating subsidiaries in Bermuda, London and Dubai. The Company was admitted to AIM in December 2005 and plans to move up to the Official List and to trading on the main market of the London Stock Exchange on 16 March 2009.

## Principal activities

The Company's principal activity, through its wholly owned subsidiaries, is the provision of global specialty insurance and reinsurance products.

## Results and dividends

A strategic dividend of $1.10 per common share and warrant was declared on 10 December 2007 and paid on 25 January 2008 in pounds sterling at the pound/U.S. dollar exchange rate of $1.9566 or £0.5622 per common share and warrant.

## Dividend Policy

Lancashire intends to maintain a strong balance sheet at all times, while generating an attractive risk-adjusted total return for shareholders. We will actively manage capital to achieve those aims. Capital management is expected to include the payment of a sustainable annual dividend, supplemented by special dividends from time to time. Dividends will be linked to past performance and future prospects. Under most scenarios, the annual dividend is not expected to reduce from one year to the next. Special dividends are expected to vary substantially in size and in timing.

## Directors

John Bishop (appointed 19 March 2008 as a Non-Executive Director)
Richard Brindle (President, Chief Executive Officer)
Simon Burton (Deputy Chief Executive Officer)
Jens Juul (Non-Executive Director)
Neil McConachie (Vice President, Chief Financial Officer)
Ralf Oelssner (Senior Independent Non-Executive Director)
Robert Spass (Non-Executive Director)
William Spiegel (Non-Executive Director)
Martin Thomas (Non-Executive Chairman)
Barry Volpert (Non-Executive Director)

## Directors' interests

The Directors' beneficial interests in the Company's common shares as at 31 December 2008 and 2007 including interests held by family members were as follows:

| Director | Common shares held at 31 December 2008 | Common shares held at 31 December 2007 |
|---|---|---|
| John Bishop | 4,807 | – |
| Richard Brindle | 430,065 | 300,000 |
| Simon Burton | 240,000 | 240,000 |
| Jens Juul | 10,000 | 10,000 |
| Neil McConachie | 47,500 | 47,500 |
| Ralf Oelssner | – | – |
| Robert Spass | 372,500 | 272,500 |
| William Spiegel | 70,240 | 70,240 |
| Martin Thomas | 6,950 | 6,950 |
| Barry Volpert | – | – |

There have been no changes in Directors' shareholdings between the end of the financial year and the date of this report.

The Directors hold warrants over the Company's shares which were awarded prior to the Company's admission to AIM in December 2005 along with other warrants awarded to the Company's founders and employees as follows: Richard Brindle 9,181,249, Simon Burton 805,555, Neil McConachie 1,160,796 and William Spiegel 481,182. In addition to the Director's interests set out above, Barry Volpert is managing member, chairman and CEO of Crestview LLC which is interested in 15,000,000 shares in the Company and 1,183,180 warrants over the Company's shares. Robert Spass is the beneficial owner of 1,549,135 warrants over the Company's shares.

Further details of the executive Director's warrants are included in the Directors' Remuneration Report.

## Transactions in own shares

The Company repurchased 9,433,168 of its own common shares from May 2008 through August 2008 for a total consideration of approximately $58.0 million as part of its $100.0 million share buyback programme authorised by the Board on 30 April 2008. The repurchased shares are held in Treasury.

## Directors' remuneration

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

# Directors' report
*continued*

## Substantial shareholders

As at 9 March 2009 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 9 March 2009 | % of shares in issue |
|---|---|---|
| Crestview Partners, L.P. | 15,000,000 | 8.7% |
| Wellington Management Company, LLP | 9,382,650 | 5.4% |
| BlackRock Merrill Lynch Investment Managers | 8,616,832 | 5.0% |
| Steadfast Capital LP | 8,564,154 | 5.0% |
| Goldman Sachs International | 6,369,675 | 3.7% |
| SAB Capital Partners, L.P. | 6,286,483 | 3.6% |
| Franklins Resources, Inc. | 5,825,871 | 3.4% |

## Corporate governance

The Company's compliance with the Combined Code on Corporate Governance 2006 is set out in the Corporate Governance section of this report.

## Donations

On 30 April 2008 the Board of Directors approved a cash donation of $1.0 million (2007 – $nil) to the Lancashire Foundation.

Lancashire set up the Lancashire Foundation, a Bermuda charitable trust in 2007 with the aim of creating a charitable trust for the benefit of charitable causes in Bermuda and elsewhere (the "Foundation"). The Foundation's trustee is an independent third party professional trust company that makes donations following recommendations made by the Company's Donations Committee consisting of Lancashire employees and independent members. Specific criteria have been set for the Foundation's charitable giving. These criteria include causes where Lancashire staff or independent Donations Committee members have a close relationship with those who operate the charity and therefore have the ability to monitor and influence outcomes.

In 2008, the Group supported The Sunshine League, The Family Centre and BASE (Bermuda Autism Support & Education Society) in Bermuda and, in recognition of the fact that a significant element of Lancashire's business is connected to insuring against natural catastrophes, the decision was taken to support Médecins Sans Frontières, a charity that the Foundation views as well equipped to provide immediate and lasting humanitarian aid to people directly affected by such catastrophes due to its international presence.

The Group did not make any political donations or expenditure during 2008.

## 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 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 commitment to the environment and is pleased with its status as Carbon Positive. The Group's office emissions have been calculated by PURE the Clean Planet Trust 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.

LUK 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.

### 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 Commission. 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").

### Special business at the Annual General Meeting
The Company's Annual General Meeting is scheduled for 1.00pm on 14 May 2009 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.

### New Bye-laws
At the Annual General Meeting of the Company to be held on 14 May 2009, a resolution to adopt new Bye-laws is to be proposed under special business of the Company. The new Bye-laws (the "New Bye-laws") update the Company's current Bye-laws to take account of changes required or relevant to a Company admitted to the Official List and to trading on the Main Market. The principal changes intended to be introduced in the New Bye-laws are set out below. Other changes, which are of a minor, technical or clarifying nature, have not been noted.

#### Definitions
The Definitions section is to be updated to insert new definitions, which are relevant to a Main Market company, and to remove definitions relating to the Company's admission to AIM in 2005.

#### Untraced shareholders
The New Bye-laws will contain an additional Bye-law which would allow Lancashire to sell, in such manner and for such price as it thinks fit, the shares of shareholders whose accounts have been dormant for a twelve year period.

#### Forfeiture of shares
The New Bye-laws will contain additional provisions relating to statutory declaration on forfeiture and extinction of all interests.

# Directors' report *continued*

**Notice**
The New Bye-laws will change the notice period for a special general meeting of the Company from 21 days to 14 days.

**Voting on resolutions**
The following amendments are to be made to Bye-law 30.1 (Voting on Resolutions): "and in the case of an equality of votes the resolution shall fail" will be changed to "In the case of an equality of votes both for and against the resolution, whether on a show of hands or on a poll, the chairman of the meeting at which the show of hands takes place or at which the poll is demanded shall be entitled to a casting vote in addition to the votes to which he may be entitled as a member or as a representative or proxy of a member"; and "In the event that a Member participates in a general meeting by telephone or electronic means, the chairman of the meeting shall direct the manner in which such Member may cast his vote on a show of hands" is to be added.

**Term of office of directors**
Bye-laws relating to the term of office of Directors in the Bye-laws will be deleted in their entirety as they refer to the admission of Lancashire to AIM. A new Bye-law will be added in place of Bye-law 48, whereby one-third of the Directors shall retire by rotation at each Annual General Meeting; the Directors eligible for retirement will include any Director wishing to retire and those who have been longest in office since their last re-election or appointment. A retiring Director (subject to the provisions of the Act and the Bye-laws) will be eligible for re-election.

**One class of directors**
Following the incorporation of the Company in 2005, the Directors were divided by the Members into three classes designated Class I, Class II and Class III. Each class of Directors consists, as nearly as possible, of one-third of the total number of Directors. References to the different classes of Directors will be removed from the New Bye-laws.

**Removal of directors**
Bye-law 50.1 the words "(in the case of Richard Brindle, only with cause until the earlier of Admission of 1 April 2006)" are to be deleted.

**Remuneration of directors**
Bye-law 50 (Remuneration of Directors) is to be amended to remove all references to the admission to AIM. The New Bye-laws will provide that the amount of any remuneration payable to Directors shall be determined by the Board and shall be deemed to accrue from day-to-day.

**Conflicts of interest**
The New Bye-laws will include an additional Bye-law to Bye-law 61 restricting any director of Lancashire from voting and counting in the quorum on a resolution concerning his/her appointment.

**Disclosure of interests in shares and company investigations**
Following Admission to the Main Market, Chapter 5 of the Disclosure and Transparency Rules will govern the disclosure of interests in shares by the Company or its Members. Bye-law 87.A (Disclosure of Interests in Shares and Company Investigations) is to be amended to delete references to AIM admission and include the provisions required under the Disclosure and Transparency Rules and which are specific to Official List companies.

**Communications**
The New Bye-laws will contain additional Bye-laws: permitting the Company to be communicated to in electronic form; and permitting the Company to communicate with its members in electronic form and also by posting documents on its website if members have agreed, in accordance with the provisions of the Companies Act 1981 of Bermuda. Please see further details in the paragraph titled Electronic and web communications below.

### Electronic and web communications

Provisions of the Companies Act 1981 of Bermuda enable companies to communicate with members by electronic and/or website communications. The Company is proposing at its next Annual General Meeting to adopt New Bye-laws to allow communications to members in electronic form and through its website. Before the Company can communicate with a member by means of website communication, the relevant member must be asked individually by the Company to agree that the Company may send or supply documents or information to him by means of a website and the Company must have received a positive response. The Company will notify the member (either in writing, or by other permitted means) when a relevant document or information is placed on the website and a member can always request a hard copy version of the document or information.

### Going concern

The business review section on pages 14 to 27 sets out details of the Group's financial performance, capital management, business environment and outlook. In addition, starting on page 61 the risk disclosures section of the financial statements sets out the major risks the Group is exposed to, including insurance, market, liquidity, operational and strategic, together with the Group's policies for monitoring and controlling its exposures to these risks.

The directors believe that the Group is well placed to manage its business risks successfully despite the current uncertain economic outlook.

After making enquiries, the directors have a reasonable expectation that the Group has adequate resources to continue its operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and accounts.

### 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.

### Disclosure of information to the auditors

Each of the persons who is a director at the date of approval of this Annual Report confirms that:

- So far as the director is aware, there is no relevant audit information of which the Company's auditors are unaware; and
- The director has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

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

**Greg Lunn, Company Secretary**
10 March 2009

# Corporate governance

Lancashire seeks to achieve the highest standards of corporate governance. Currently, the Company complies with the Combined Code on Corporate Governance as revised in 2006 (the "Combined Code") except as stated in this Corporate Governance section of this Annual Report. There are no Bermudian corporate governance standards similar to the Combined Code that apply to Lancashire.

## Board and committee administration

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. The day-to-day management of the Company and implementation of Board decisions and strategy are carried out by the executive Directors and senior management. The Board and its committees meet on a quarterly basis and occasionally more frequently as circumstances dictate. At Board meetings, the Directors review all areas and developments in the Group's business and receive reports from management on finance, underwriting and any other key matters affecting the Company. The Directors are provided with information necessary for it to fulfill its responsibilities including quarterly reports and full board papers. Additional information is provided to the Directors as and when necessary and the Directors have access to independent professional advice as required.

## Meeting attendance schedule

The Board and committee attendance record during 2008 of the directors who held office at the end of the year is as follows:

| | Board(1) | Audit committee | Nomination and corporate governance committee | Remuneration committee |
|---|---|---|---|---|
| **Non-executive directors** | | | | |
| John Bishop | 3/3(2) | 3/3(2) | 3/3(2) | – |
| Jens Juul | 3/4 | 3/3(2) | 3/3(2) | 3/3(2) |
| Ralf Oelssner | 3/4 | 3/4 | – | 4/4 |
| Robert Spass | 4/4 | 3/4 | – | – |
| William Spiegel | 4/4 | 4/4 | – | 4/4 |
| Martin Thomas | 4/4 | – | 4/4 | 4/4 |
| Barry Volpert | 3/4 | – | 1/1(2) | – |
| **Executive directors** | | | | |
| Richard Brindle | 4/4 | – | 1/1(2) | – |
| Simon Burton | 4/4 | – | – | – |
| Neil McConachie | 4/4 | – | – | – |

(1) Excludes meetings of committees of the Board appointed to complete business approved by the Board or routine business.
(2) Adjusted for appointment or resignation from Board/committee if during the year.

### The directors

John Bishop, Jens Juul, Ralf Oelssner, Martin Thomas and William Spiegel are independent 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 1 May 2007. Robert Spass and Barry Volpert are not independent under the Combined Code due to their appointment by and affiliation with specific shareholders.

Accordingly, four out of the ten 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, excluding the Chairman, should make up at least half of the Board. The Company is seeking to appoint an additional non-executive director during 2009 and is actively pursuing suitable candidates.

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 II Directors, Richard Brindle and Barry Volpert, were re-appointed at the 2008 Annual General Meeting held on 30 April 2008 to hold office until 2010. Ralf Oelssner, Robert Spass and William Spiegel are the Class I Directors and will accordingly be submitting themselves for re-election for a further three years by the Company's shareholders at the Annual General Meeting scheduled to take place on 14 May 2009 as detailed in the notice of Annual General Meeting accompanying this report.

As described in the Directors' Report above, the Company is proposing to adopt a new Bye-law requiring Directors to retire by rotation. One-third of the Directors shall retire by rotation at each Annual General Meeting. The Directors eligible for re-election will be those who have been longest in office since their last re-lection or appointment. This will replace the existing "Class" system but in practice will not change how the Director rotation operates.

### 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. From the date of the Company's admission to the Official List and to trading on the Main Market, information regarding the obligations of the Company to comply with the Listing Rules of the Financial Services Authority will also be 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

Evaluation of the Board's performance was carried out in the second half of 2008, 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 2009.

# Corporate governance *continued*

## Relations with shareholders

Throughout 2008, the Head of Investor Relations and Marketing and 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 2008. 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.

## Committees

The Board has established audit, nomination and corporate governance, remuneration, investment and underwriting committees. Each of the committees has detailed terms of reference, which can be viewed on the Company's website (www.lancashiregroup.com). The committees are generally scheduled to meet quarterly prior to the Board meetings at which they report. The composition of the committees as at 31 December 2008 was as follows:

| | Audit committee | Nomination and corporate governance committee | Remuneration committee | Investment committee | Underwriting committee |
|---|---|---|---|---|---|
| Martin Thomas | | ✓(chair) | ✓ | | |
| John Bishop | ✓ | ✓ | | | ✓ |
| Jens Juul | ✓ | ✓ | ✓ | | ✓ |
| Ralf Oelssner | ✓ | | ✓ | | ✓ |
| Robert Spass | ✓(chair) | | | ✓ | |
| William Spiegel | ✓ | | ✓(chair) | | |
| Barry Volpert | | | | ✓(chair) | |
| Richard Brindle | | | | ✓ | ✓(chair) |
| Simon Burton | | | | | ✓ |
| Neil McConachie | | | | ✓ | |

## Audit committee

The members of the audit committee are Robert Spass (Chair), John Bishop, Jens Juul, Ralf Oelssner and William Spiegel. The composition of the committee currently does not conform to the Combined Code requirement that the committee should be comprised of independent non-executive Directors. Robert Spass, although a non-executive Director, is not considered independent for the purposes of the Combined Code. All the other members are independent non-executive Directors. However, the Board considers that the audit committee's current membership is appropriate and that Robert Spass is suitable for the role of audit committee chair because he has recent and relevant financial experience. 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.

### Nomination and corporate governance committee

The members of the nomination and corporate governance committee are Martin Thomas (Chair), John Bishop and Jens Juul. 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.

### Remuneration committee

The members of the remuneration committee are William Spiegel (Chair), Jens Juul, Ralf Oelssner and Martin Thomas. 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.

### Investment committee

The members of the investment committee are Barry Volpert (Chair), Richard Brindle, Neil McConachie, and Robert Spass. The investment committee's responsibilities are contained in their 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.

### Underwriting committee

The director members of the underwriting committee are Richard Brindle (Chair), John Bishop, Simon Burton, Jens Juul and Ralf Oelssner. Additional members of the underwriting committee, who are not directors, are Bryan Bumsted, Charles Mathias, Paula Porter and Alex Maloney. The positions and summaries of the experience of these non-director members of the underwriting committee can be found on the Company's website at www.lancashiregroup.com. 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.

### 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. While retaining overall responsibility for risk management, including establishing the Group's overall risk profile and risk tolerances, the Board has assigned 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 identify promptly, significant risks facing the Group so that such risks remain within the tolerance levels agreed by the Board. The Board acknowledges that the Group cannot eliminate all risks, but believes that comprehensive assessment and management of the risks facing the Group enable 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 2008, the audit committee reviewed the effectiveness of the Group's internal controls and risk management systems, reviewed the Group's financial reporting and held closed sessions respectively with the Group's internal and external auditors and with management.

# Corporate governance *continued*

### Internal audit

The Internal audit department's audit plan is designed to cover annually all areas of the Group's business carrying the highest risk to the achievements of the Group's objectives. All other areas of the Group's operations will be audited at least once every three years. The internal audit department reports directly to the audit committee and the audit plan is approved by the audit committee.

In mid 2008, the Company expanded its internal audit team. Findings of the internal audits and implementation of agreed management actions are reviewed by the audit committee at each of its meetings.

In 2008, on the recommendation of the audit committee and to provide additional resources for the work of the internal audit team, the Company also renewed the engagement of PricewaterhouseCoopers, who carried out internal audits and reported on the Group's internal controls and processes in respect of information technology change management and security compliance and compliance with tax operating guidelines.

### 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 are safeguarded. The Board is responsible for reviewing the effectiveness of the external audit which is reported on by the audit committee. In 2008, Ernst & Young performed certain non-audit services in relation to: the Company's application for admission on the Official List of the London Stock Exchange; transfer pricing and taxation advisory. During 2008, 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

In November 2008, Steve Sumner assumed the role as Group Chief Risk Officer and, building on the investment made in this area, together with the ongoing support of the internal audit department, 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. During 2008, the Group extensively reviewed its risk registers, and risk owners reviewed and formally affirmed the accuracy of risk and controls on a quarterly basis. The Group 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 continuous independent monitoring and evaluation of management's risk and activities by the Group internal audit team will add additional strength in this area.

# Directors' remuneration report

## Directors' remuneration report

As a company incorporated in Bermuda, the UK Directors' Remuneration Report Regulations 2002 do not apply to Lancashire. However, the Board is committed to providing information to shareholders and complying with corporate governance standards and best practices to the appropriate extent, taking into account the Company's size and the nature of its business.

All information shown is unaudited.

## Remuneration committee

The Remuneration Committee comprised the following members during the year and to the date of this report (all of whom are independent non-executive Directors excluding Martin Thomas, the Chairman of the Board, who was independent on appointment):

William Spiegel (Chair)
Jens Juul
Ralf Oelssner
Martin Thomas

The Remuneration Committee's responsibilities are contained in their terms of reference, a copy of which is available on the Company's website. These responsibilities include determining remuneration for the Company's executive Directors and senior management of the Group within a framework agreed with the Board.

## Advice to the remuneration committee

During 2008, Hewitt New Bridge Street ("HNBS") were appointed by the Remuneration Committee to give advice on market trends, practices and appropriate levels of remuneration for executive Directors and members of senior management. HNBS 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 4 January 2008. HNBS did not provide any other services to the Company during 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 2008.

Meetings of the Remuneration Committee may also be attended by other Directors including the Chief Executive Officer and Chief Financial Officer, but such attendance is by invitation only and not by right. The Chairman and the executive Directors are not involved in determining their own remuneration.

## Remuneration policy

The Company's remuneration policy is geared towards providing a level of remuneration which attracts, retains and motivates executive Directors and senior management of the highest calibre to further the Company's interests and to optimise long-term shareholder value creation. The remuneration policy also seeks to ensure that executive Directors and senior management are provided with appropriate incentives to drive individual performance and to fairly reward them for their contribution to the successful performance of the Company.

The Remuneration Committee has adopted the principle that base salary should be set broadly in line with the median for executives in a role of comparable standing and that executive Directors should be able to achieve total remuneration at the upper quartile level (compared to peer companies generating similar returns) when justified by superior performance. The Remuneration Committee also takes into account levels of pay elsewhere in the Group, when determining the pay levels for executive Directors and senior executives.

# Directors' remuneration report *continued*

The details of the component parts of the remuneration package for executive Directors are set out below.

## Remuneration of executive directors

The executive Directors' remuneration is made up of the following elements:

- Base salary
- Bonus
- Long-term share-based incentives ('restricted shares')
- Pension
- Other benefits, including medical, dental, vision coverage, air travel and housing and other allowance for expatriates.

An appropriate balance is maintained between fixed remuneration and variable (performance–related) remuneration. Variable remuneration is made up of an appropriate mix of short-term and long-term incentives. At a level of 'target' performance or better, the level of variable pay comprises a significant majority of the overall package.

**Base salary**

Salaries for executive Directors are determined by the Remuneration Committee before the start of each year and where an individual changes responsibility or position. The Company needs to offer salaries at around median market levels so that it is able to attract and retain executive Directors and senior executives of a suitable calibre to execute the Company's strategic plans and provide long-term shareholder value creation. The Remuneration Committee also takes into account pay levels elsewhere in the Group when setting the salary levels for executive Directors and senior executives.

From 1 January 2009, the salaries for executive Directors have been increased as follows: Richard Brindle, Chief Executive Officer – no increase; Simon Burton, Deputy Chief Executive Officer – a 3 per cent inflationary increase; and Neil McConachie, Chief Financial Officer – by 4.5 per cent increase to reflect the market value of the individual and his role.

**Annual bonus**

The Company operates a cash bonus plan based on annual performance of the Company and the individual executive.

The Company performance element is based on growth in book value and Return on Equity ("ROE") against the business plan approved by the Board and a relative ROE versus peer companies. Individual performance metrics will be set at the start of the financial year and assessed by way of a performance rating.

The level of bonus in 2008 was capped at 400 per cent, 350 per cent and 325 per cent (400 per cent, 350 per cent and 350 per cent for 2009) of salary for the Chief Executive, Deputy Chief Executive and Chief Financial Officer, respectively. The target level of bonus is half of the maximum.

**Long-term incentives**

**Restricted share scheme (the "RSS")**

In 2008, the Company introduced a new restricted share scheme. Under the RSS, executives may be granted a conditional award of shares which are released to the executive after three years, subject to the achievement of stretching performance conditions and continued employment. The purpose of awards under the RSS is 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. The executive Directors are eligible to receive share awards under the RSS at the discretion of the Remuneration Committee. Awards are made each year following the announcement of preliminary results.

The Remuneration Committee has considered carefully the grant levels and performance conditions for awards in 2009. Award levels will be 318,750 restricted shares for the Chief Executive and 93,125 shares for the Deputy Chief Executive and 99,375 for the Chief Financial Officer with the actual number of shares received subject to satisfaction of time and performance conditions as set out below.

For half of each award the performance condition will be based on the Company's total shareholder return ("TSR") performance against a comparator group of international insurance companies over a three year period measured from the date of grant. 25 per cent of this part of the award will vest if the Company's TSR is equal to the company whose TSR is ranked at the median. All of this part of the award will vest if the Company's TSR is equal to the company whose TSR is ranked at the upper quartile or above. Vesting will take place on a straight line between 25 per cent and 100 per cent for TSR performance between median and upper quartile.

For the remaining half of each award the performance condition is based on ROE over three financial years in the performance period. 25 per cent of this award will only vest if average annual ROE over the performance period exceeds 3-month U.S.$ LIBOR calculated on a daily basis plus 8 per cent. All of this part of the award will vest if the Company's average ROE is equal to 3-month U.S.$ LIBOR calculated on a daily basis plus 18 per cent. Vesting will take place on a straight line basis between 25 per cent and 100 per cent for ROE performance.

TSR and ROE were chosen as performance criteria on the basis that TSR provides an objective reward for stock market out-performance of the Company's peers and ROE provides a focus on underlying financial performance.

**Pension**

Executive directors 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 the pension contributions made to executive Directors are set out on page 45.

**Other benefits**

Other benefits for executive Directors comprise medical, dental and vision coverage, air travel and housing and other allowances for expatriates.

## Service contracts

The executive Directors of the Company are Richard Brindle, Simon Burton and Neil McConachie. Richard Brindle was appointed as Chief Executive Officer of the Company under an original service contract dated 9 December 2005. Neil McConachie was appointed as Chief Financial Officer under an original service contract dated 1 February 2006. Simon Burton was appointed Deputy Chief Executive Officer under an original service contract dated 1 January 2007.

Richard Brindle's, Simon Burton's and Neil McConachie's original service contracts with the Company have been replaced with new service contracts entered into with effect from 1 January 2009. All service contracts contain six month notice provisions by either party. Details of the salaries payable under these contracts are set out in the emoluments table on page 45.

In the event of early termination, the executive Directors' contracts provide for compensation up to a maximum of base annual salary plus the fair value of benefits to which the executive Directors are contractually entitled for the unexpired portion of the notice period. The Company seeks to apply the principle of mitigation in the payment of compensation on the termination of the service contract of any executive Director. There are no special provisions in the service contracts for payments to executive Directors on a change of control of the Company.

The Board may allow executive Directors to accept external appointments. In accordance with the Combined Code, the Board will not agree to a full-time executive taking on more than one non-executive directorship, or the chairmanship of any company.

# Directors' remuneration report *continued*

## Non-executive directors

### Remuneration policy

The Company'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 the Company's size and complexity. 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.

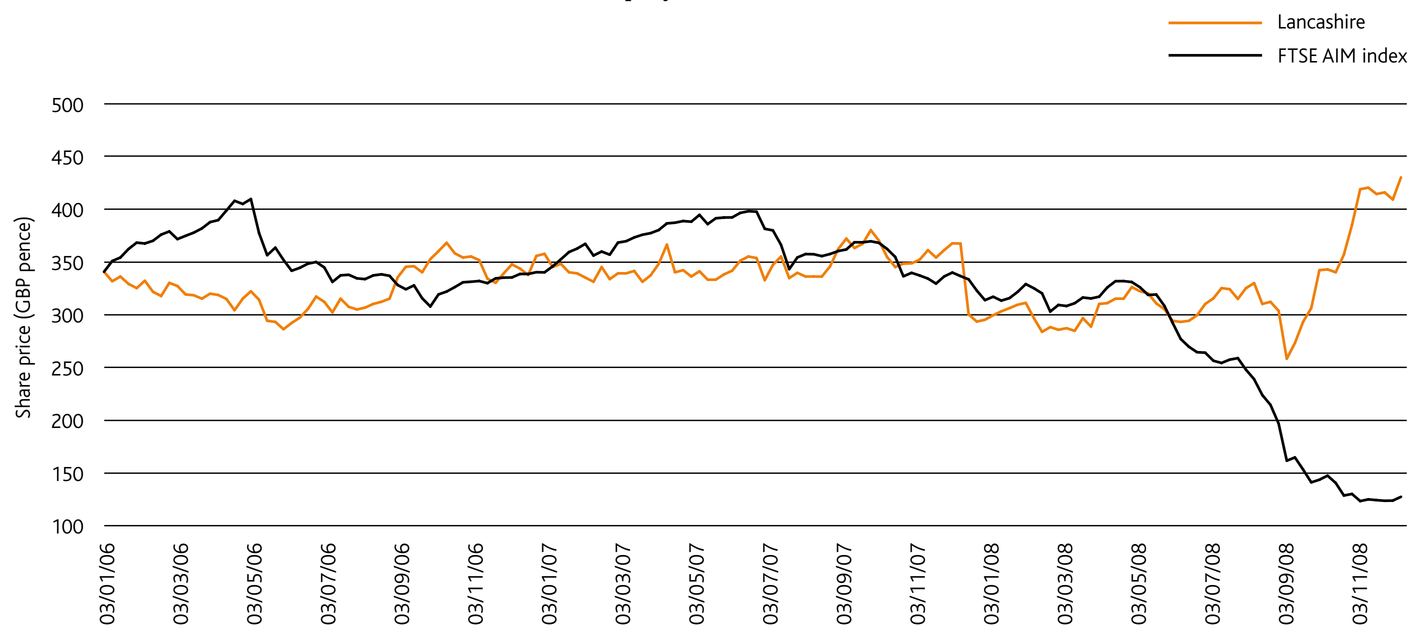
### Terms of appointment

The non-executive Directors serve subject to the Company's Bye-laws and under letters of appointment and are appointed for varying terms which are terminable by either party on six months' notice with absence of earlier termination in accordance with the Bye-laws. 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 letters of appointment are available for inspection at Annual General Meetings.

| Name | Position | Date of letter of appointment | Date of next re-appointment |
|---|---|---|---|
| John Bishop | Non-executive director | 19 March 2008 | 2010 AGM |
| Jens Juul | Non-executive director | 16 November 2007 | 2011 AGM |
| Ralf Oelssner | Non-executive director, senior independent director | 31 July 2007 | 2009 AGM |
| Robert Spass | Non-executive director, chairman of audit committee | 9 December 2005 | 2009 AGM |
| William Spiegel | Non-executive director, chairman of remuneration committee | 9 December 2005 | 2009 AGM |
| Martin Thomas | Non-executive chairman | 16 April 2007 | 2010 AGM |
| Barry Volpert | Non-executive director | 12 December 2005 | 2011 AGM |

## Relative performance

The following graph shows the Company's performance, measured by TSR, compared with the performance of the FTSE AIM Index. This index has been chosen because it best reflects the Company's nature and size.



## Directors' emoluments

Directors' emoluments for the year ended 31 December 2008.

| Director | Base salary/fees | Other(i)(ii) | Benefits(i)(iv) | Pension(i) | Annual bonus(v) | Total 2008 emoluments | Total 2007 emoluments |
|---|---|---|---|---|---|---|---|
| **Non-executive directors** | | | | | | | |
| Martin Thomas | 275,000 | 100,000 | – | – | – | 375,000 | 332,005 |
| John Bishop | 109,603 | 42,464 | – | – | – | 152,067 | – |
| Jens Juul | 140,000 | – | – | – | – | 140,000 | 17,500 |
| Ralf Oelssner | 175,000 | 48,000 | – | – | – | 223,000 | 206,736 |
| Robert Spass | 175,000 | – | – | – | – | 175,000 | 166,784 |
| William Spiegel | 175,000 | – | – | – | – | 175,000 | 164,086 |
| Barry Volpert | 140,000 | – | – | – | – | 140,000 | 133,483 |
| **Executive directors** | | | | | | | |
| Richard Brindle | 675,000 | 447,292 | 329,267 | 64,729(iii) | 1,561,753 | 3,078,041 | 6,713,424 |
| Simon Burton | 386,250 | – | 182,406 | 20,000 | 512,023 | 1,100,679 | 2,385,406 |
| Neil McConachie | 381,037 | – | 178,904 | 20,000 | 530,642 | 1,110,584 | 1,775,676 |

(i) Some amounts were paid in pounds sterling and converted at prevailing exchange rates.
(ii) Martin Thomas receives a fee of $100,000 per annum for his appointment as non-executive Chairman of LUK. John Bishop and Ralf Oelssner are also non-executive Directors of LUK and each receives fees of $30,000 per annum and $2,000 for each LUK Board or committee meeting that they attend in respect of their appointments. In addition, John Bishop receives a fee of $5,000 per annum in respect of his chairmanship of the LUK Audit Committee. Richard Brindle receives an annual salary of £235,465 from LUK in respect his employment.
(iii) Including a contribution of £23,547 in 2008 (2007 – £23,547) to a UK defined contribution pension plan in respect of Richard Brindle's salary and employment with LUK.
(iv) Benefits include UK national insurance contributions, payroll taxes, medical, dental, vision coverage, air travel and housing and other allowances paid by the Company for expatriates.
(v) Provisional number as final audited results of peer companies are awaited in order to calculate the final bonus payable.

# Directors' remuneration report *continued*

## Directors' warrants, options and RSS awards

### (i) Time vesting ordinary warrants

| Name | Warrants held at 1 January 2008 | Warrants granted during the year | Warrants exercised during the year | Warrants lapsed during the year | Warrants held at 31 December 2008 | Exercise price[ii] | Date from which exercisable[i] | Expiry date |
|---|---|---|---|---|---|---|---|---|
| **Richard Brindle** | | | | | | | | |
| 16/12/05 | 7,625,217 | – | – | – | 5,718,913 | $5.00 | 16/12/05 | 16/12/15 |
| 16/12/05 | – | – | – | – | 1,906,304 | $3.90 | 16/12/08 | 16/12/15 |
| **Simon Burton** | | | | | | | | |
| 09/03/06 | 444,804 | – | – | – | 333,603 | $5.00 | 09/03/06 | 16/12/15 |
| 09/03/06 | – | – | – | – | 111,201 | $3.90 | 16/12/08 | 16/12/15 |
| 21/09/06 | 114,378 | – | – | – | 86,083 | $5.00 | 21/09/06 | 16/12/15 |
| 21/09/06 | – | – | – | – | 28,295 | $3.90 | 16/12/08 | 16/12/15 |
| **Neil McConachie** | | | | | | | | |
| 16/12/05 | 453,152 | – | – | – | 294,293 | $5.00 | 16/12/05 | 16/12/15 |
| 16/12/05 | – | – | – | – | 158,859 | $3.90 | 16/12/08 | 16/12/15 |
| 09/03/06 | 317,717 | – | – | – | 158,859 | $5.00 | 09/03/06 | 16/12/15 |
| 09/03/06 | – | – | – | – | 158,858 | $3.90 | 16/12/08 | 16/12/15 |

(i) The time-vesting ordinary warrants vested 25 per cent on issuance on the admission of the Company's shares to trading on AIM on 16 December 2005. 25 per cent of each warrant then vested on each of the first, second and third anniversaries of the admission of the Company's shares to trading on AIM.

(ii) On 10 December 2007, the Company declared a strategic dividend of $1.10 per common share payable to shareholders of record, 11 January 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 25 January 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. The contractual obligation to pay a dividend equivalent on each vested warrant, and to adjust the exercise price for all unvested warrants, applies to all past, present and future dividends declared by the Company.

The market value of the common shares on each date of grant was 16/12/2005: £3.21; 09/03/2006: £3.27 and 21/09/2006: £3.44.

### (ii) Performance vesting ordinary warrants

| Name | Warrants held at 1 January 2008 | Warrants granted during the year | Warrants exercised during the year | Warrants lapsed during the year | Warrants held at 31 December 2008 | Exercise price[(ii)] | Date from which first exercisable[(i)] | Expiry date |
|---|---|---|---|---|---|---|---|---|
| **Richard Brindle** | | | | | | | | |
| 16/12/05 | 2,745,078 | – | – | 1,189,046 | 288,843 | $5.00 | 31/12/07 | 16/12/15 |
| 16/12/05 | – | – | – | – | 1,267,189 | $3.90 | 31/12/08 | 16/12/15 |
| **Simon Burton** | | | | | | | | |
| 09/03/06 | 240,196 | – | – | 104,042 | 25,274 | $5.00 | 31/12/07 | 16/12/15 |
| 09/03/06 | – | – | – | – | 110,880 | $3.90 | 31/12/08 | 16/12/15 |
| 21/9/06 | 194,443 | | – | 84,224 | 20,460 | $5.00 | 31/12/07 | 16/12/15 |
| 21/9/06 | – | – | – | – | 89,759 | $3.90 | 31/12/08 | 16/12/15 |
| **Neil McConachie** | | | | | | | | |
| 16/12/05 | 343,135 | – | – | 148,631 | 36,105 | $5.00 | 31/12/07 | 16/12/15 |
| 16/12/05 | – | – | – | – | 158,859 | $3.90 | 31/12/08 | 16/12/15 |
| 09/03/06 | 343,135 | – | – | 148,631 | 36,105 | $5.00 | 31/12/07 | 16/12/15 |
| 09/03/06 | – | – | – | – | 158,858 | $3.90 | 31/12/08 | 16/12/15 |

(i) The performance warrants were scheduled to vest in three tranches: 20 per cent on 31 December 2007, 40 per cent on 31 December 2008 and the remaining 40 per cent on 31 December 2009. As a result of the compound IRR target for 2007 and 2008 not being met a number of performance warrants lapsed. The 40 per cent of the originally issued number of performance warrants that remain outstanding will vest on 31 December 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. 50 per cent of the 40 per cent will vest if the compound IRR target is met and the other 50 per cent of the 40 per cent will vest if the fully converted book value target is met. There are minimums established for both targets below which zero warrants will vest.

(ii) On 10 December 2007, the Company declared a strategic dividend of $1.10 per common share payable to shareholders of record, 11 January 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 2 April 2008 (and once the performance conditions had been verified), the Company paid a dividend of £0.5622 per warrant on all of the vested performance warrants, reflecting the dividend paid to shareholders. This resulted in a payment of $162,388 to Richard Brindle, $25,711 to Simon Burton and $40,597 to Neil McConachie. These payments were made once the exact number of vested performance warrants was 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. The exercise price for the unvested ordinary and performance warrants has been adjusted downwards by $1.10 to $3.90 per warrant. The contractual obligation to pay a dividend equivalent on each vested warrant, and to adjust the exercise price for all unvested warrants, applies to all past, present and future dividends declared by the Company.

The market value of the common shares on each date of grant was 16/12/2005: £3.21; 09/03/2006: £3.27 and 21/09/2006: £3.44.

# Directors' remuneration report *continued*

### (iii) Share options under the 2005 LTIP

| Name | Options held at 1 January 2008 | Options granted during the year | Options exercised during the year | Options lapsed during the year | Options held at 31 December 2008 | Exercise price(ii) | Date from which first exercisable(i) | Expiry date |
|---|---|---|---|---|---|---|---|---|
| **Richard Brindle** | | | | | | | | |
| 09/03/06 | 762,522 | – | – | – | 762,522 | £2.69 | 09/03/07 | 08/03/16 |
| 29/06/07 | 150,000 | – | – | – | 150,000 | $5.77 | 29/06/08 | 28/06/17 |
| **Simon Burton** | | | | | | | | |
| 09/05/07 | 300,000 | – | – | – | 300,000 | $6.01 | 09/05/08 | 08/05/17 |
| 29/06/07 | 500,000 | – | – | – | 500,000 | $5.77 | 29/06/08 | 28/06/17 |
| **Neil McConachie** | | | | | | | | |
| 09/03/06 | 508,348 | – | – | – | 508,348 | £2.69 | 09/03/07 | 08/03/16 |
| 29/06/07 | 200,000 | – | – | – | 200,000 | $5.77 | 29/06/08 | 28/06/17 |

(i) The share options under the 2005 LTIP were not subject to any performance conditions.
(ii) 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.
(iii) Following an amendment to the 2005 LTIP, approved by the Company's shareholders at the special general meeting of shareholders held on 4 January 2008, 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 9 January 2008. The adjustment was made to reflect the strategic dividend paid by the Company in January 2008, and the consequent reduction in shareholders' equity.
(iv) No LTIP options were exercised by Directors during 2008.

The market value of the Common Shares on each date of grant was 09/03/2006: £3.27; 09/05/2007: £3.57 and 29/06/2007: £3.42.

### (iv) Awards under the restricted share scheme

| Name | Awards held at 1 January 2008 | Awards granted during the year | Awards exercised during the year | Awards lapsed during the year | Awards held at 31 December 2008 | Vesting date[ii] |
|---|---|---|---|---|---|---|
| **Richard Brindle** | | | | | | |
| Performance award | – | 360,001 | – | – | 360,001 | 28/03/11 |
| Exceptional award[iii] | – | 33,381 | – | – | 33,381 | 28/03/11 |
| **Simon Burton** | | | | | | |
| Performance award | – | 109,378 | – | – | 109,378 | 28/03/11 |
| Exceptional award[iii] | – | 22,254 | – | – | 22,254 | 28/03/11 |
| **Neil McConachie** | | | | | | |
| Performance award | – | 101,032 | – | – | 101,032 | 28/03/11 |
| Exceptional award[iii] | – | 22,254 | – | – | 22,254 | 28/03/11 |

(i) The market value of the common shares on the date of grant (28 March 2008) was £2.86.
(ii) The vesting of 2008 RSS awards is subject to two performance conditions. Half of each award is subject to a performance condition measuring the Total Shareholder Return ("TSR") performance of the Company against the TSR performance of a select group of comparator companies, over a three-year performance period. 25 per cent of this half of an award vests for median performance by the Company, rising to 100 per cent vesting of this half of the award for upper quartile performance by the Company or better (with straight-line vesting between these two points). The comparator group of companies comprises Amlin, Arch Capital, Axis Capital, Endurance, Flagstone, Hiscox, IPC, Montpelier, Partner Re, Platinum, Ren Re and Validus. The other half of each award is subject to a performance condition based on average annual return on equity ("ROE") over a three-year performance period. If average annual ROE is between the 3-month U.S. Dollar LIBOR calculated on a daily basis plus 8 per cent. and the 3-month U.S. Dollar LIBOR calculated on a daily basis plus 13 per cent., between 0 per cent and 50 per cent of this half of the award will vest, on a straight-line basis. If average annual ROE is between the 3-month U.S. Dollar LIBOR calculated on a daily basis plus 13 per cent. and the three-month U.S. Dollar LIBOR calculated on a daily basis plus 18 per cent. or more, between 50 per cent and 100 per cent of this half of the award will vest, on a straight-line basis.
(iii) The exceptional RSS awards were made in 2008 to assist in the continuing incentivisation of executives between the closure in January 2008 of the LTIP to further awards and the future vesting of the RSS awards made subject to performance conditions.

The market value of the common shares at 31 December 2008 was £4.25 and the range during the year was £2.58 to £4.25.

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

# Statement of Directors' responsibilities

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 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.

# Independent auditors' report 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 31 December 2008 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 Introduction, Lancashire at a Glance, Chairman's Statement, Business Overview, Business Review, Directors' Report, Corporate Governance, 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 31 December 2008, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

10 March 2009
#3 Reid Street
Hamilton, Bermuda

## Consolidated income statement for the year ended 31 December 2008

| | Notes | 2008 $m | 2007 $m |
|---|---|---|---|
| Gross premiums written | 2 | 638.1 | 753.1 |
| Outwards reinsurance premiums | 2 | (63.4) | (86.3) |
| **Net premiums written** | | **574.7** | **666.8** |
| Change in unearned premiums | 2 | 42.2 | (56.1) |
| Change in unearned premiums on premium ceded | 2 | (9.6) | 0.5 |
| **Net premiums earned** | | **607.3** | **611.2** |
| Net investment income | 3 | 59.5 | 78.4 |
| Net other investment income (losses) | 3, 20 | 0.1 | (3.3) |
| Net realised (losses) gains and impairments | 3 | (11.0) | 9.1 |
| Net fair value (losses) gains on investments at fair value through profit and loss | 3 | (0.6) | 0.4 |
| Share of (loss) profit of associate | 12 | (0.2) | 6.2 |
| Net foreign exchange (losses) gains | | (8.5) | 2.3 |
| **Total net revenue** | | **646.6** | **704.3** |
| Insurance losses and loss adjustment expenses | 2 | 418.8 | 150.0 |
| Insurance losses and loss adjustment expenses recoverable | 2 | (43.3) | (3.7) |
| **Net insurance losses** | | **375.5** | **146.3** |
| Insurance acquisition expenses | 2, 4 | 106.9 | 95.6 |
| Insurance acquisition expenses ceded | 2, 4 | (7.3) | (19.1) |
| Other operating expenses | 5, 6, 7, 23 | 59.9 | 74.9 |
| **Total expenses** | | **535.0** | **297.7** |
| **Results of operating activities** | | **111.6** | **406.6** |
| Financing costs | 19, 20 | 14.0 | 14.7 |
| **Profit before tax** | | **97.6** | **391.9** |
| Tax | 8, 9 | 0.1 | 1.0 |
| **Profit for the year attributable to equity shareholders** | | **97.5** | **390.9** |
| **Earnings per share** | | | |
| Basic | 24 | $0.55 | $2.01 |
| Diluted | 24 | $0.53 | $1.91 |

## Consolidated balance sheet as at 31 December 2008

| | Notes | 2008 $m | 2007 $m |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | 10 | 413.6 | 737.3 |
| Accrued interest receivable | 14 | 10.1 | 9.8 |
| Investments | | | |
| – Fixed income securities | | | |
| – Available for sale | 11 | 1,595.4 | 1,069.7 |
| – At fair value through profit and loss | 11 | 4.0 | 23.5 |
| – Equity securities | | | |
| – Available for sale | 11 | 5.8 | 71.6 |
| – Other investments | 11, 20 | – | 4.4 |
| Investment in associate | 12 | – | 22.9 |
| Reinsurance assets | | | |
| – Unearned premium on premium ceded | 13 | 10.0 | 19.6 |
| – Reinsurance recoveries | 13, 14 | 42.1 | 3.6 |
| – Other receivables | 13, 14 | 3.2 | 8.2 |
| Deferred acquisition costs | 15 | 60.9 | 57.8 |
| Other receivables | 14 | 154.0 | 3.8 |
| Inwards premium receivable from insureds and cedants | 14 | 187.3 | 198.2 |
| Deferred tax asset | 9 | 1.2 | 2.0 |
| Property, plant and equipment | 18 | 1.4 | 2.3 |
| **Total assets** | | **2,489.0** | **2,234.7** |
| **Liabilities** | | | |
| Insurance contracts | | | |
| – Losses and loss adjustment expenses | 13 | 528.8 | 179.6 |
| – Unearned premiums | 13 | 339.6 | 381.8 |
| – Other payables | 13, 16 | 17.6 | 16.5 |
| Amounts payable to reinsurers | 13, 16 | 2.0 | 5.7 |
| Deferred acquisition costs ceded | 17 | 1.9 | 3.1 |
| Other payables | 16 | 190.3 | 296.2 |
| Corporation tax payable | 8 | – | 1.2 |
| Interest rate swap | 20 | 4.9 | 2.2 |
| Accrued interest payable | 19 | 0.4 | 0.5 |
| Long-term debt | 19 | 130.8 | 132.3 |
| **Total liabilities** | | **1,216.3** | **1,019.1** |
| **Shareholders' equity** | | | |
| Share capital | 21, 22 | 91.1 | 91.1 |
| Treasury shares | 21 | (58.0) | – |
| Share premium | | 60.1 | 49.5 |
| Contributed surplus | 27 | 754.8 | 754.8 |
| Fair value and other reserves | 3, 11 | 27.6 | 20.7 |
| Retained earnings | | 397.1 | 299.5 |
| **Total shareholders' equity attributable to equity shareholders** | | **1,272.7** | **1,215.6** |
| **Total liabilities and shareholders' equity** | | **2,489.0** | **2,234.7** |

The consolidated financial statements were approved by the Board of Directors on 10 March 2009 and signed on its behalf by:

Martin Thomas Neil McConachie

## Consolidated statement of changes in shareholders' equity for the year ended 31 December 2008

| | Notes | Share capital $m | Treasury shares $m | Share premium $m | Contributed surplus $m | Fair value and other reserves $m | Retained earnings $m | Total $m |
|---|---|---|---|---|---|---|---|---|
| **Balance as at 31 December 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 | 8 | – | – | – | – | (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 | 16, 21 | – | – | – | – | – | (38.6) | (38.6) |
| Warrant issues – management and performance | 6, 21, 22 | 0.1 | – | 10.8 | (1.6) | – | – | 9.3 |
| Option issues | 6, 22 | – | – | 5.1 | – | – | – | 5.1 |
| **Balance as at 31 December 2007** | | **91.1** | **–** | **49.5** | **754.8** | **20.7** | **299.5** | **1,215.6** |
| Profit for the year | | – | – | – | – | – | 97.5 | 97.5 |
| Change in investment unrealised gains (losses) | 3, 11 | – | – | – | – | 7.1 | – | 7.1 |
| Corporation tax | 8 | – | – | – | – | (0.2) | – | (0.2) |
| **Total recognised income for the year** | | **–** | **–** | **–** | **–** | **6.9** | **97.5** | **104.4** |
| Shares repurchased | 21 | – | (58.0) | – | – | – | – | (58.0) |
| Dividends on common shares | | – | – | – | – | – | 0.1 | 0.1 |
| Warrant issues – management and performance | 6, 22 | – | – | 2.4 | – | – | – | 2.4 |
| Option issues | 6, 22 | – | – | 6.7 | – | – | – | 6.7 |
| Restricted stock issues | 6, 22 | – | – | 1.5 | – | – | – | 1.5 |
| **Balance as at 31 December 2008** | | **91.1** | **(58.0)** | **60.1** | **754.8** | **27.6** | **397.1** | **1,272.7** |

## Consolidated cash flow statement for the year ended 31 December 2008

| | Notes | 2008 $m | 2007 $m |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Profit before tax | | 97.6 | 391.9 |
| Tax paid | | (0.9) | (2.4) |
| Depreciation | 7, 18 | 1.1 | 1.4 |
| Interest expense | 19 | 9.8 | 11.6 |
| Interest and dividend income | | (59.6) | (79.3) |
| Amortisation of fixed income securities | | – | (0.7) |
| Equity based compensation | 5, 6 | 10.6 | 14.4 |
| Foreign exchange | | 9.4 | (3.1) |
| Share of loss (profit) of associate | 12 | 0.2 | (6.2) |
| Net other investment (income) losses | 3, 20 | (0.1) | 3.3 |
| Net realised losses (gains) and impairments | 3 | 11.0 | (9.1) |
| Net fair value losses (gains) on investments at fair value through profit and loss | 3 | 0.6 | (0.4) |
| Unrealised loss on interest rate swaps | 20 | 2.7 | 1.3 |
| Reinsurance assets | | | |
| – Unearned premium on premium ceded | 13 | 9.6 | (0.5) |
| – Reinsurance recoveries | 13 | (38.5) | (3.5) |
| – Other receivables | 13 | 5.0 | (8.2) |
| Deferred acquisition costs | 15 | (3.1) | (6.3) |
| Other receivables | 14 | (150.2) | 2.4 |
| Inwards premium receivable from insureds and cedants | | 8.2 | (23.8) |
| Insurance contracts | | | |
| – Losses and loss adjustment expenses | 13 | 349.8 | 140.0 |
| – Unearned premiums | 13 | (42.2) | 56.2 |
| – Other payables | | 2.0 | 11.3 |
| Amounts payable to reinsurers | 16 | (3.7) | 4.9 |
| Deferred acquisition costs ceded | 17 | (1.2) | 0.5 |
| Other payables | | 142.6 | 25.8 |
| **Net cash flows from operating activities** | | **360.7** | **521.5** |
| **Cash flows used in investing activities** | | | |
| Interest and dividends received | | 59.4 | 77.0 |
| Purchase of property, plant and equipment | 18 | (0.2) | (1.3) |
| Dividends received from associate | 12 | 22.7 | 6.5 |
| Purchase of fixed income securities | 26 | (3,882.4) | (2,143.3) |
| Purchase of equity securities | | (31.9) | (30.9) |
| Proceeds on maturity and disposal of fixed income securities | 26 | 3,402.6 | 1,960.4 |
| Proceeds on disposal of equity securities | | 66.7 | 36.9 |
| Net proceeds on other investments | | 4.5 | 5.1 |
| **Net cash flows used in investing activities** | | **(358.6)** | **(89.6)** |
| **Cash flows used in financing activities** | | | |
| Interest paid | | (10.0) | (11.6) |
| Dividends paid | 26 | (238.2) | – |
| Shares repurchased | 21, 26 | (68.3) | (89.3) |
| **Net cash flows used in financing activities** | | **(316.5)** | **(100.9)** |
| **Net (decrease) increase in cash and cash equivalents** | | **(314.4)** | **331.0** |
| Cash and cash equivalents at beginning of year | | 737.3 | 400.1 |
| Effect of exchange rate fluctuations on cash and cash equivalents | | (9.3) | 6.2 |
| **Cash and cash equivalents at end of year** | 10 | **413.6** | **737.3** |

## Accounting policies for the year ended 31 December 2008

### 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, the Group 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.

There are no new or amended IFRS and International Financial Reporting Interpretations Committee ("IFRIC") standards adopted by or materially impacting the Group.

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. The new standard is not expected to have a material impact on the results and disclosures reported in the consolidated financial statements.

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

### Use of estimates

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

The most significant estimate made by management is in relation to losses and loss adjustment expenses. This is discussed on page 58 and also in the risk disclosures section from page 61.

Estimates may also be made in determining the estimated fair value of certain financial instruments. This is discussed in the risk disclosures section from page 61. Management judgement is applied in determining impairment charges.

### 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.

## Accounting policies for the year ended 31 December 2008

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.

## Accounting policies for the year ended 31 December 2008

### (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 programmes is inherently complicated in that losses in excess of the attachment level of the Group's policies are characterised by high severity and low frequency and other factors which could vary significantly as losses are settled. This limits the volume of industry loss experience available from which to reliably predict ultimate losses following a loss event. In addition, the Group has limited past loss experience, which increases the inherent uncertainty in estimating ultimate loss levels.

Losses and loss adjustment expenses represent the estimated ultimate cost of settling all losses and loss adjustment expenses arising from events which have occurred up to the balance sheet date, including a provision for IBNR. The Group does not discount its liabilities for unpaid losses. Outstanding losses are initially set on the basis of reports of losses received from third parties. 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 amortised 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 securities are quoted investments that are classified as available for sale or fair value through profit and loss 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 1 January 2007 are designated as at fair value through profit and loss. Movements in estimated fair value relate primarily to the option component. The option component of securities with an embedded conversion option purchased prior to 1 January 2007 is included in other investments. 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 profit and loss are recognised in current period income.

## Accounting policies for the year ended 31 December 2008

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, such as expected cash flows, do not support a recovery in value. If an impairment is deemed appropriate, the difference between cost or amortised cost and estimated fair value is removed from 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.

## Accounting policies for the year ended 31 December 2008

### Employee benefits

**(i) Equity compensation plans**

The Group operates a management warrant plan, an option plan and a restricted share scheme. 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, options and restricted shares 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.

### Treasury shares

Treasury shares are deducted from shareholders' equity. No gain or loss is recognised on the purchase, sale, cancellation or issue of treasury shares and any consideration paid or received is recognised directly in equity.

## Risk disclosures for the year ended 31 December 2008

### 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") programme. 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 Board of Directors receives and considers reports from the Risk Committees. The Board of Directors sets the overall risk profile and risk appetite for the Group.

The Risk Committees define tolerance levels over categories of risk for the operating entities. This includes the level of capital the operating entities are willing to expose to certain risks. Identification of emerging and monitoring already recognised risks is the responsibility of individual risk owners. The CRO is responsible for monitoring the adherence to these. Any breaches are reported to the Risk Committees, and thus to the Board of Directors. Risk owners periodically perform an exercise to identify the Group's most significant risks. 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.

### Economic capital model

The Group has developed a sophisticated economic capital model ("BLAST"). BLAST provides information on risk and return that can assist with business decisions. BLAST is an integral part of the Group's ERM programme. 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 programmes, loss ratios, default rates, asset performance 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. BLAST includes the calculation of present and projected financial outcomes for each insurance class, including non-elemental classes. BLAST also recognises diversification credit. This arises as individual risks are generally not strongly correlated and are unlikely to all produce profits or losses at the same time. Diversification credit is calculated within categories, most notably within the insurance category, and across a range of risk categories. BLAST helps the Group 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 including 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 their 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 risks, including risks exposed to both natural and man-made catastrophes. The Group's exposure in connection with insurance contracts is, in the event of insured losses, whether 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.

## Risk disclosures for the year ended 31 December 2008

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:

- The Group has a rolling three year strategic plan, adopted in the second quarter each year, which sets the overriding business goals that the Board aims to achieve;
- 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, opportunities and emerging risks;
- 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; and
- Reinsurance may be 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.

A number of lines of business are subject to seasonal variation. A proportion of the Group's business is exposed to large catastrophe losses in North America as a result of windstorms. The level of windstorm activity, and landfall thereof, during the North American hurricane season may materially impact the Group's loss experience. The typical North American hurricane season is June to November. The Group also bears exposure to large losses arising from other non-seasonal natural catastrophes, such as earthquakes, from risk losses throughout the year and from war, terrorism and political risk. Given seasonality, the risk of a very large earthquake is more relevant than U.S. hurricanes at 31 December 2008.

As part of the Group's risk management process the BLAST model is typically run on a fortnightly basis. This enables the management team to monitor exposures to pre-determined elemental and non-elemental event risk tolerances. BLAST is also employed in the Group's budgeting and forecasting process. The Group's exposure to certain events, as a percentage of capital, including long-term debt, are shown below, net of tax, after collection of reinsurance and after payment and collection of reinstatement premiums.

| | 31 December 2008 | | 31 December 2007 | |
|---|---|---|---|---|
| | $m | % | $m | % |
| California earthquake | 249.8 | 17.8 | 249.3 | 18.5 |
| Gulf of Mexico windstorm | 246.6 | 17.6 | 317.2 | 23.5 |
| European windstorm | 143.4 | 10.2 | 244.0 | 18.1 |
| New Madrid earthquake | 27.3 | 1.9 | 59.5 | 4.4 |
| Northeast U.S. earthquake | 7.3 | 0.5 | 0.9 | 0.1 |

The windstorm events have an assumed probability of 1 in 100 years with the earthquake events at 1 in 250 years.

## Risk disclosures for the year ended 31 December 2008

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 earthquake loss with an occurrence probability of greater than 1 in 250 years or a modeled windstorm loss 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:

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | $m | % | $m | % |
| Property | 302.7 | 47.5 | 309.3 | 41.1 |
| Energy | 185.2 | 29.0 | 282.7 | 37.5 |
| Marine | 78.6 | 12.3 | 76.9 | 10.2 |
| Aviation | 71.6 | 11.2 | 84.2 | 11.2 |
| **Total** | **638.1** | **100.0** | **753.1** | **100.0** |

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

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | $m | % | $m | % |
| Worldwide offshore | 232.6 | 36.5 | 268.1 | 35.6 |
| Worldwide, including the U.S. and Canada(1) | 124.2 | 19.4 | 205.0 | 27.2 |
| U.S. and Canada | 112.8 | 17.7 | 127.2 | 16.9 |
| Worldwide, excluding the U.S. and Canada(2) | 48.5 | 7.6 | 49.8 | 6.6 |
| Europe | 42.0 | 6.6 | 43.2 | 5.7 |
| Far East | 17.3 | 2.7 | 17.3 | 2.3 |
| Middle East | 12.4 | 1.9 | 13.5 | 1.8 |
| Rest of World | 48.3 | 7.6 | 29.0 | 3.9 |
| **Total** | **638.1** | **100.0** | **753.1** | **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 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:

| | 2008 $m | 2007 $m |
|---|---|---|
| Property direct and facultative | 93.8 | 122.8 |
| Property retrocession | 76.4 | 88.5 |
| Terrorism | 75.5 | 56.6 |
| Property political risk | 28.1 | 16.9 |
| Property cat excess of loss | 23.4 | 19.3 |
| Other property | 5.5 | 5.2 |
| **Total** | **302.7** | **309.3** |

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.

## Risk disclosures for the year ended 31 December 2008

Property retrocession is written on an excess of loss basis through treaty arrangements. Programmes 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 windstorm 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 exposures 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 pages 62 and 63.

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.

Reinsurance may be purchased to mitigate exposures to large natural catastrophe losses in the U.S. and Canada. Reinsurance may also be purchased to reduce the Group's worldwide exposure to large risk losses.

### b. Energy

Gross premiums written, for the year:

| | 2008 $m | 2007 $m |
|---|---|---|
| Worldwide offshore energy | 76.3 | 72.7 |
| Gulf of Mexico offshore energy | 74.3 | 157.5 |
| Construction energy | 21.5 | 24.5 |
| Onshore energy | 10.0 | 25.3 |
| Other energy | 3.1 | 2.7 |
| **Total** | **185.2** | **282.7** |

Energy risks are mostly written on a direct basis. Gulf of Mexico energy programmes 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 pages 62 and 63. Most policies have sub-limits on coverage for elemental losses. Non-elemental energy risks include fire and explosion.

Worldwide offshore energy programmes 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.

Reinsurance protection may be purchased to protect a portion of loss from elemental and non-elemental energy claims.

### c. Marine

Gross premiums written, for the year:

| | 2008 $m | 2007 $m |
|---|---|---|
| Marine hull and total loss | 30.6 | 29.4 |
| Marine builders risk | 26.3 | 22.3 |
| Marine hull war | 11.3 | 11.4 |
| Marine P&I clubs | 9.2 | 9.4 |
| Marine excess of loss | – | 4.4 |
| Other marine | 1.2 | – |
| **Total** | **78.6** | **76.9** |

## Risk disclosures for the year ended 31 December 2008

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 programmes are not normally written. The largest expected exposure is from physical loss rather than from elemental loss events.

Reinsurance may be purchased to reduce the Group's exposure to both large risk losses and an accumulation of smaller, attritional losses.

**d. Aviation**

Gross premiums written, for the year:

| | 2008 $m | 2007 $m |
|---|---|---|
| AV52 | 51.2 | 63.1 |
| Aviation reinsurance | 13.7 | 10.7 |
| Other aviation | 6.7 | 10.4 |
| **Total** | **71.6** | **84.2** |

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 is mostly satellite cover. Other aviation business includes aviation hull war risks.

Reinsurance may be purchased to mitigate exposures to an AV52 event loss.

### 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 Group regularly reviews its catastrophe exposures and may purchase reinsurance in order to reduce the Group's net exposure to a large natural catastrophe loss and/or to reduce net exposures to other large losses. There is no guarantee that reinsurance coverage will be available to meet all potential loss circumstances, as it is possible that the cover purchased is not sufficient. Any loss amount which exceeds the programme would be retained by the Group. Some parts of the reinsurance programme have limited reinstatements therefore the number of claims which may be recovered from second or subsequent losses in those particular circumstances is limited.

### Insurance liabilities

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

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

**Risk disclosures** for the year ended 31 December 2008

### Insurance liabilities *continued*

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 subject to a quarterly corroborative review by independent actuaries, using U.S. generally accepted actuarial principles. The independent review is presented to the Group's Audit Committee. The Group has established a Reserve Committee which has responsibility for the review of large claims, their development and also any changes in reserving methodology and assumptions on a quarterly basis.

The extent of reliance on management's judgement in the reserving process differs as to whether the business is insurance or reinsurance, whether it is short-tail or long-tail and whether the business is written on an excess of loss or on a pro-rata basis. Over a typical annual period, the Group expects to write the large majority of programmes on a direct basis. Typically, over 80% of programmes 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 makes the available data more volatile and less useful for predicting ultimate losses. In the case of proportional contracts, reliance is placed on an analysis of a contract's historical experience, industry information, and the professional judgement of underwriters in estimating reserves for these contracts. In addition, if available, reliance is placed partially on ultimate loss ratio forecasts as reported by insureds or cedants, which are normally subject to a quarterly or six month lag.

**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 31 December 2008 management's estimates for IBNR represented 32.6% of total net loss reserves (2007 – 60.1%). The majority of the estimate relates to potential claims on non-elemental risks where timing delays in insured or cedant reporting may mean losses could have occurred which the Group were not made aware of by the balance sheet date.

## B. Market risk

The Group is at risk of loss due to movements in market factors. 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 cash flow needs following an extreme event. The funds to cover this potential liability are designated as the "core" portfolio and the portfolio duration is matched to the duration of the insurance liabilities. The core portfolio is invested in fixed income securities and cash and cash equivalents. The core portfolio may, at times, contain assets significantly in excess of those required to meet insurance liabilities. 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 to provide liquidity to meet claims and capital preservation.

Assets in excess of those required to settle potential insurance liabilities in an extreme event, may be held in the core portfolio, the "core plus" portfolio or in the "surplus" portfolio. The core plus portfolio is invested in fixed income securities and cash and cash equivalents. The surplus portfolio is invested in fixed income securities, cash and cash equivalents and can invest in equity securities and derivative instruments. The assets in the core plus and surplus portfolios are not matched to specific insurance liabilities.
In general, the duration may be slightly longer than in the core portfolio, while maintaining focus on high quality assets. The Group also holds a modest amount of convertible debt securities in its surplus portfolio. 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 profit and loss 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 three external investment managers with similar mandates. The equity portfolio is managed by one investment manager. The equity portfolio has been liquidated with less than 1% of the total investment portfolio remaining in equities at 31 December 2008. The performance of the managers is monitored on an on-going basis.

## Risk disclosures for the year ended 31 December 2008

Asset allocation by manager is as follows:

| As at 31 December 2008 | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|
| | Goldman Sachs | Blackrock | Pimco | Equity manager | Total |
| Fixed income securities | 711.0 | 589.2 | 294.9 | 4.3 | 1,599.4 |
| Equity securities | – | – | – | 5.8 | 5.8 |
| Cash and cash equivalents | 36.7 | 112.3 | 37.6 | 0.5 | 187.1 |
| **Total** | **747.7** | **701.5** | **332.5** | **10.6** | **1,792.3** |

| | % | % | % | % | % |
|---|---|---|---|---|---|
| Fixed income securities | 39.7 | 32.9 | 16.5 | 0.2 | 89.3 |
| Equity securities | – | – | – | 0.3 | 0.3 |
| Cash and cash equivalents | 2.0 | 6.3 | 2.1 | – | 10.4 |
| **Total** | **41.7** | **39.2** | **18.6** | **0.5** | **100.0** |

| As at 31 December 2007 | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|
| | Goldman Sachs | Blackrock | Pimco | 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 and cash equivalents | 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 and cash equivalents | 5.2 | 17.6 | – | 0.5 | 23.3 |
| **Total** | **46.5** | **45.3** | **–** | **8.2** | **100.0** |

**Risk disclosures** for the year ended 31 December 2008

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

| As at 31 December 2008 | $m | % | $m | % | $m | % | $m | % |
|---|---|---|---|---|---|---|---|---|
| | Core | | Core plus | | Surplus | | Total | |
| **Available for sale** | | | | | | | | |
| – Short-term investments | 101.5 | 6.4 | 9.9 | 0.6 | 52.2 | 3.3 | 163.6 | 10.3 |
| – U.S. treasuries | 148.3 | 9.3 | 15.8 | 1.0 | 27.6 | 1.7 | 191.7 | 12.0 |
| – Other government bonds | 27.7 | 1.7 | 11.4 | 0.7 | 15.0 | 0.9 | 54.1 | 3.3 |
| – U.S. government agency debt | 39.5 | 2.5 | 15.5 | 1.0 | 59.5 | 3.7 | 114.5 | 7.2 |
| – U.S. government agency mortgage backed securities | 180.9 | 11.3 | 82.2 | 5.1 | 351.3 | 22.0 | 614.4 | 38.4 |
| – Corporate bonds | 138.3 | 8.6 | 52.0 | 3.2 | 113.2 | 7.1 | 303.5 | 18.9 |
| – Corporate bonds – FDIC guaranteed[1] | 108.8 | 6.8 | 14.6 | 0.9 | 30.0 | 1.9 | 153.4 | 9.6 |
| – Convertible debt securities | – | – | – | – | 0.2 | – | 0.2 | – |
| **Available for sale** | **745.0** | **46.6** | **201.4** | **12.5** | **649.0** | **40.6** | **1,595.4** | **99.7** |
| **At fair value through profit and loss** | | | | | | | | |
| – Convertible debt securities | – | – | – | – | 4.0 | 0.3 | 4.0 | 0.3 |
| **Total fixed income securities** | **745.0** | **46.6** | **201.4** | **12.5** | **653.0** | **40.9** | **1,599.4** | **100.0** |

| As at 31 December 2007 | $m | % | $m | % | $m | % | $m | % |
|---|---|---|---|---|---|---|---|---|
| | Core | | Core plus | | Surplus | | Total | |
| **Available for sale** | | | | | | | | |
| – Short-term investments | – | – | – | – | 0.7 | 0.1 | 0.7 | 0.1 |
| – U.S. treasuries | 207.9 | 19.0 | – | – | 46.5 | 4.3 | 254.4 | 23.3 |
| – U.S. government agency debt | 195.7 | 17.9 | – | – | 13.6 | 1.2 | 209.3 | 19.1 |
| – U.S. government agency mortgage backed securities | 153.5 | 14.0 | – | – | 87.6 | 8.0 | 241.1 | 22.0 |
| – Non-agency mortgage backed securities | 6.0 | 0.6 | – | – | 1.0 | 0.1 | 7.0 | 0.7 |
| – Corporate bonds | 309.8 | 28.3 | – | – | 33.5 | 3.1 | 343.3 | 31.4 |
| – Convertible debt securities | – | – | – | – | 13.9 | 1.3 | 13.9 | 1.3 |
| **Available for sale** | **872.9** | **79.8** | **–** | **–** | **196.8** | **18.1** | **1,069.7** | **97.9** |
| **At fair value through profit and loss** | | | | | | | | |
| – Convertible debt securities | – | – | – | – | 23.5 | 2.1 | 23.5 | 2.1 |
| **Total fixed income securities** | **872.9** | **79.8** | **–** | **–** | **220.3** | **20.2** | **1,093.2** | **100.0** |

(1) FDIC guaranteed corporate bonds are protected by the Federal Deposit Insurance Corporation, an independent agency of the United States government.

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 31 December 2008 would be $0.6 million (2007 – $7.2 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.

**Risk disclosures** for the year ended 31 December 2008

The sector allocation of the corporate bonds and convertible debt securities is as follows:

| Sector | 31 December 2008 $m | 31 December 2008 % | 31 December 2007 $m | 31 December 2007 % |
|---|---|---|---|---|
| Industrial | 172.7 | 37.5 | 123.3 | 32.4 |
| Financial | 254.6 | 55.2 | 234.3 | 61.5 |
| Utility | 15.7 | 3.4 | 19.5 | 5.1 |
| Other | 18.1 | 3.9 | 3.6 | 1.0 |
| **Total** | **461.1** | **100.0** | **380.7** | **100.0** |

The financial sector allocation includes $153.4 million (2007 – $nil) of FDIC guaranteed bonds.

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 detailed below, assuming linear sensitivity to movements in interest rates.

| Immediate shift in yield (basis points) | 31 December 2008 $m | 31 December 2008 % | 31 December 2007 $m | 31 December 2007 % |
|---|---|---|---|---|
| 100 | (43.1) | (2.7) | (25.9) | (2.4) |
| 75 | (32.3) | (2.0) | (19.5) | (1.8) |
| 50 | (21.6) | (1.4) | (13.0) | (1.2) |
| 25 | (10.8) | (0.7) | (6.5) | (0.6) |
| (25) | 6.6 | 0.4 | 5.7 | 0.5 |
| (50) | 13.1 | 0.8 | 11.4 | 1.0 |
| (75) | 19.7 | 1.2 | 17.1 | 1.6 |
| (100) | 26.2 | 1.6 | 22.8 | 2.1 |

(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 portfolios response to changes in interest rates has been factored into the data above.

The Group limits interest rate risk on the investment portfolio by establishing and monitoring duration ranges within investment guidelines. The duration of the core portfolio is matched to the duration of the insurance reserves. The permitted duration range for the core plus portfolio is between zero and four years and for the surplus portfolio it is between one and five years. The duration of the fixed income portfolios at 31 December 2008 was 1.7 years for the core portfolio (2007 – 1.9), 1.4 years for the core plus portfolio (2007 – not applicable) and 2.6 years for the surplus portfolio (2007 – 3.4).

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

## Risk disclosures for the year ended 31 December 2008

The Group's VaR calculations are as follows:

| | 31 December 2008 | | 31 December 2007 | |
|---|---|---|---|---|
| | $m | % | $m | % |
| 95th percentile confidence level | 43.1 | 3.4 | 15.2 | 1.3 |
| 99th percentile confidence level | 60.9 | 4.8 | 21.4 | 1.8 |

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

(i) quoted prices in active markets for the same instrument; or
(ii) quoted prices on active markets for similar assets or liabilities or other valuation techniques for which all significant inputs are based on observable market data; or
(iii) valuation techniques for which any significant input is not based on observable market data.

Securities that have quoted prices in active markets include publicly traded equity securities and U.S. treasuries.

Securities that have their fair value estimated based on observable market data include:

- U.S. government agency debt;
- U.S. government agency mortgage backed securities;
- Non-agency mortgage backed securities;
- Corporate bonds;
- Convertible debt securities; and
- Non-publicly traded equity securities.

Prices for the Group's investment portfolio are provided by a third party investment accounting firm whose pricing processes, and the controls thereon, are subject to an annual audit on both the operation and the effectiveness of those controls – a "SAS 70" audit. SAS 70 audit reports are publicly available to clients of the firm and the report is reviewed annually by management. In accordance with their pricing policy, various recognised reputable pricing sources are used including index providers, broker dealers, and pricing vendors. The pricing sources use bid prices where available, otherwise indicative prices are quoted based on observable market trade data. The prices provided are compared to the investment managers' and custodian's pricing.

The majority of the Group's assets are invested in U.S. government or U.S. government agency securities which are less subject to pricing risk.

**Risk disclosures** for the year ended 31 December 2008

**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 rates and/or terms and conditions for certain lines, or across all lines;
- The actions and reactions of key competitors, which may directly result in volatility in premium volumes and rates, fee levels and other input costs; and
- 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:

- Reviews and amends underwriting plans and budgets as necessary;
- Reduces exposure to market sectors where conditions have reached unattractive levels;
- Purchases appropriate reinsurance cover to mitigate exposure;
- Closely monitors changes in rates, and terms and conditions; and
- Regularly reviews output from the Group's economic capital model, BLAST, to assess up-to-date profitability of classes and sectors.

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

**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 $97.0 million | 15 December 2035 | 15 December 2011 | 50% |
| Subordinated loan notes €24.0 million | 15 June 2035 | 15 March 2011 | 50% |

The notional amounts of $50.0 million and €12.0 million respectively are due on 15 March 2011.

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

The current Euribor interest rate on 50% of the Euro subordinated loan notes has been fixed at 3.33% (2007 – 4.95%). The current LIBOR interest rate on 50% of the U.S. dollar subordinated loan notes has been fixed at 2.00% (2007 – 4.99%). The Group has no interest rate risk on the remaining portion of the notes.

**Risk disclosures** for the year ended 31 December 2008

### d. Currency risk

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

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

The Group 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 €24.0 million subordinated loan notes long-term debt liability.

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

| Assets | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|
| | U.S. $ | Sterling | Euro | Other | total |
| Cash and cash equivalents | 368.8 | 7.6 | 33.9 | 3.3 | 413.6 |
| Accrued interest receivable | 10.1 | – | – | – | 10.1 |
| Investments | | | | | |
| – Fixed income securities | | | | | |
| – Available for sale | 1,595.4 | – | – | – | 1,595.4 |
| – At fair value through profit and loss | 4.0 | – | – | – | 4.0 |
| – Equity securities | | | | | |
| – Available for sale | 5.8 | – | – | – | 5.8 |
| Reinsurance assets | 55.3 | – | – | – | 55.3 |
| Deferred acquisition costs | 48.8 | 1.7 | 5.5 | 4.9 | 60.9 |
| Other receivables | 152.2 | 1.7 | – | 0.1 | 154.0 |
| Inwards premium receivable from insureds and cedants | 143.9 | 7.8 | 25.0 | 10.6 | 187.3 |
| Deferred tax asset | – | 1.2 | – | – | 1.2 |
| Property, plant and equipment | 0.1 | 1.2 | – | 0.1 | 1.4 |
| **Total assets as at 31 December 2008** | **2,384.4** | **21.2** | **64.4** | **19.0** | **2,489.0** |

| Liabilities | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|
| | U.S. $ | Sterling | Euro | Other | total |
| Losses and loss adjustment expenses | 488.2 | 3.1 | 20.0 | 17.5 | 528.8 |
| Unearned premiums | 274.2 | 14.0 | 26.6 | 24.8 | 339.6 |
| Insurance contracts – other payables | 13.3 | 0.2 | 3.2 | 0.9 | 17.6 |
| Amounts payable to reinsurers | 1.9 | 0.1 | – | – | 2.0 |
| Deferred acquisition costs ceded | 1.9 | – | – | – | 1.9 |
| Other payables | 184.3 | 5.8 | 0.2 | – | 190.3 |
| Interest rate swap | 4.4 | – | 0.5 | – | 4.9 |
| Accrued interest payable | 0.2 | – | 0.2 | – | 0.4 |
| Long-term debt | 97.0 | – | 33.8 | – | 130.8 |
| **Total liabilities as at 31 December 2008** | **1,065.4** | **23.2** | **84.5** | **43.2** | **1,216.3** |

**Risk disclosures** for the year ended 31 December 2008

| 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 | | | | | |
| – Fixed income securities | | | | | |
| – Available for sale | 1,069.7 | – | – | – | 1,069.7 |
| – At fair value through profit and loss | 23.5 | – | – | – | 23.5 |
| – Equity securities | | | | | |
| – Available for sale | 71.6 | – | – | – | 71.6 |
| – Other investments | 4.4 | – | – | – | 4.4 |
| Investment in associate | 22.9 | – | – | – | 22.9 |
| Reinsurance assets | 31.4 | – | – | – | 31.4 |
| 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 and cedants | 159.1 | 11.4 | 18.3 | 9.4 | 198.2 |
| Deferred tax asset | – | 2.0 | – | – | 2.0 |
| Property, plant and equipment | 0.6 | 1.6 | – | 0.1 | 2.3 |
| **Total assets as at 31 December 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 | 323.8 | 15.7 | 23.9 | 18.4 | 381.8 |
| 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 | 3.1 | – | – | – | 3.1 |
| 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 31 December 2007** | **887.7** | **30.9** | **76.3** | **24.2** | **1,019.1** |

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 $0.4 million (2007 – $28.2 million).

## Risk disclosures for the year ended 31 December 2008

### 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:

| As at 31 December 2008 | $m | $m | $m | $m |
|---|---|---|---|---|
| | Core | Core plus | Surplus | Total |
| Less than one year | 184.4 | 22.2 | 69.8 | 276.4 |
| Between one and two years | 128.8 | 30.8 | 39.9 | 199.5 |
| Between two and three years | 157.7 | 48.7 | 63.7 | 270.1 |
| Between three and four years | 61.7 | 8.9 | 20.8 | 91.4 |
| Between four and five years | 18.4 | 6.8 | 27.0 | 52.2 |
| Over five years | 13.1 | 1.8 | 80.5 | 95.4 |
| Mortgage backed securities | 180.9 | 82.2 | 351.3 | 614.4 |
| **Total** | **745.0** | **201.4** | **653.0** | **1,599.4** |

| As at 31 December 2007 | $m | $m | $m | $m |
|---|---|---|---|---|
| | Core | Core plus | Surplus | Total |
| Less than one year | 45.8 | – | 2.0 | 47.8 |
| Between one and two years | 347.6 | – | 29.9 | 377.5 |
| Between two and three years | 166.4 | – | 5.8 | 172.2 |
| Between three and four years | 56.6 | – | 15.4 | 72.0 |
| Between four and five years | 75.3 | – | 14.7 | 90.0 |
| Over five years | 21.7 | – | 63.9 | 85.6 |
| Mortgage backed securities | 159.5 | – | 88.6 | 248.1 |
| **Total** | **872.9** | **–** | **220.3** | **1,093.2** |

## Risk disclosures for the year ended 31 December 2008

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

| As at 31 December 2008 | $m | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|---|
| | | Years until liability becomes due – undiscounted values | | | | |
| | Balance sheet | Less than one | One to three | Three to five | Over five | Total |
| Losses and loss adjustment expenses | 528.8 | 188.5 | 211.0 | 72.2 | 57.1 | 528.8 |
| Insurance contracts – other payables | 17.6 | 14.0 | 3.2 | 0.4 | – | 17.6 |
| Amounts payable to reinsurers | 2.0 | 2.0 | – | – | – | 2.0 |
| Other payables | 190.3 | 190.3 | – | – | – | 190.3 |
| Interest rate swap | 4.9 | 2.1 | 2.8 | – | – | 4.9 |
| Accrued interest payable | 0.4 | 0.4 | – | – | – | 0.4 |
| Long-term debt | 130.8 | 7.9 | 15.8 | 15.8 | 303.4 | 342.9 |
| **Total** | **874.8** | **405.2** | **232.8** | **88.4** | **360.5** | **1,086.9** |

| As at 31 December 2007 | $m | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|---|
| | | Years until liability becomes due – undiscounted values | | | | |
| | Balance sheet | Less than one | One to three | Three to five | Over five | Total |
| Losses and loss adjustment expenses | 179.6 | 64.4 | 71.8 | 24.2 | 19.2 | 179.6 |
| Insurance contracts – other payables | 16.5 | 15.3 | 0.8 | 0.4 | – | 16.5 |
| Amounts payable to reinsurers | 5.7 | 5.7 | – | – | – | 5.7 |
| Other payables | 296.2 | 296.2 | – | – | – | 296.2 |
| Corporation tax payable | 1.2 | 1.2 | – | – | – | 1.2 |
| Interest rate swap | 2.2 | 0.7 | 1.3 | 0.2 | – | 2.2 |
| Accrued interest payable | 0.5 | 0.5 | – | – | – | 0.5 |
| Long-term debt | 132.3 | 11.5 | 23.0 | 23.0 | 395.0 | 452.5 |
| **Total** | **634.2** | **395.5** | **96.9** | **47.8** | **414.2** | **954.4** |

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. While the estimation of the ultimate liability for losses and loss adjustment expenses is complex and incorporates a significant amount of judgement, the timing of payment of losses and loss adjustment expenses is also uncertain and cannot be predicted as simply as for other financial liabilities. Actuarial and statistical techniques, past experience and management's judgement have been used to determine a likely settlement pattern.

The Group manages its liquidity risks via its investment strategy to hold high quality, highly liquid securities, sufficient to meet its insurance liabilities and other near term liquidity requirements. The creation of the core portfolio with its subset of guidelines 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. The Group 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.

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 65.

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.

| As at 31 December 2008 | $m | $m | $m | $m |
|---|---|---|---|---|
| | Equity securities and other investments | Cash and fixed income securities | Inwards premium receivable and other receivables | Reinsurance recoveries |
| AAA | – | 1,572.6 | – | – |
| AA+, AA, AA- | – | 207.9 | – | – |
| A+, A, A- | – | 190.8 | 3.2 | 42.1 |
| BBB+, BBB, BBB- | – | 38.9 | – | – |
| Other | 5.8 | 2.8 | 341.3 | – |
| **Total** | **5.8** | **2,013.0** | **344.5** | **42.1** |

| As at 31 December 2007 | $m | $m | $m | $m |
|---|---|---|---|---|
| | Equity securities and other investments | Cash and fixed income securities | Inwards premium receivable and other receivables | Reinsurance recoveries |
| 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** |

The counter-party to the Group's interest rate swap is currently rated AA by Standard & Poor's.

## Risk disclosures for the year ended 31 December 2008

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

| | 31 December 2008 $m | 31 December 2007 $m |
|---|---|---|
| Less than 90 days past due | 4.3 | 21.6 |
| Between 91 and 180 days past due | 1.4 | 0.7 |
| Over 180 days past due | 0.5 | 0.8 |
| **Total** | **6.2** | **23.1** |

Provisions of $1.5 million (2007 – $0.3 million) 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 or systems including the risk of fraud, safety, damage to physical assets, business disruption, system failure and transaction processing failure. Business may also be disrupted by a rating agency action, loss of key personnel, or changes in local employment restrictions.

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. The Group addresses 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 reviewed by the Board of Directors quarterly. 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 31 December 2008 is determined as $1,403.5 million (2007 – $1,347.9 million) comprising $1,272.7 million of shareholders' equity (2007 – $1,215.6 million) and $130.8 million of long-term debt (2007 – $132.3 million). The Group's capital requirements vary with the insurance cycle.

The Group 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 within 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.

**Risk disclosures** for the year ended 31 December 2008

### b. Value creation and risk adjusted return

The Group's aim is to provide its shareholders with a 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 is expected to be the largest driver of this pattern. Management monitors these peaks and troughs – adjusting the Group's portfolio to make the most effective use of available capital and seeking to maximise the risk-adjusted return.

IRR achieved is as follows:

| | Annual return | Compound annual return | Inception to date return |
|---|---|---|---|
| 31 December 2005[1] | (3.2%) | n/a | (3.2%) |
| 31 December 2006 | 17.4% | 13.6% | 13.6% |
| 31 December 2007 | 31.7% | 22.3% | 49.6% |
| 31 December 2008 | 7.5% | 17.7% | 63.1% |

IRR achieved in excess of the 3 month treasury yield is as follows:

| | Annual return | Compound annual return | Inception to date return |
|---|---|---|---|
| 31 December 2005[1] | (3.4%) | n/a | (3.4%) |
| 31 December 2006 | 12.6% | 8.8% | 8.8% |
| 31 December 2007 | 27.2% | 17.7% | 40.1% |
| 31 December 2008 | 6.1% | 14.1% | 52.1% |

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

## Notes to the accounts for the year ended 31 December 2008

### 1. General information

The Group is a provider of global property insurance and reinsurance products. LHL was incorporated under the laws of Bermuda on 12 October 2005. LHL is listed on AIM, a subsidiary market of the London Stock Exchange ("LSE"). A secondary listing on the Bermuda Stock Exchange ("BSX") was approved on 21 May 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 ("LIHL"), Lancashire Insurance Marketing Services Limited ("LIMSL"), Lancashire Insurance Services Limited ("LISL") and Lancashire Marketing Services (Middle East) Limited ("LMEL"). LIHL is a holding company for a wholly owned operating subsidiary, Lancashire Insurance Company (UK) Limited ("LUK").

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

| | LICL | LIHL | LUK | LIMSL | LISL | LMEL |
|---|---|---|---|---|---|---|
| Date of incorporation | 28 October 2005 | 11 April 2006 | 17 March 2006 | 7 October 2005 | 17 March 2006 | 11 March 2007 |
| Licensing body | BMA[(1)] | None | FSA[(2)] | FSA[(2)] | None | DFSA[(3)] |
| Nature of business | General insurance business | Holding company | General insurance business | Insurance mediation activities | Support services | Insurance mediation activities |

(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 – for the year ended 31 December 2008**

| **Gross premiums written** | **$m** | **$m** | **$m** | **$m** | **$m** |
|---|---|---|---|---|---|
| | **Property** | **Energy** | **Marine** | **Aviation** | **Total** |
| Analysed by geographical segment: | | | | | |
| Worldwide offshore | 0.9 | 159.1 | 72.6 | – | 232.6 |
| Worldwide, including the U.S. and Canada[(1)] | 44.5 | 7.2 | 2.1 | 70.4 | 124.2 |
| U.S. and Canada | 108.5 | 4.2 | 0.1 | – | 112.8 |
| Worldwide, excluding the U.S. and Canada[(2)] | 47.5 | 0.5 | 0.2 | 0.3 | 48.5 |
| Europe | 34.1 | 4.6 | 2.9 | 0.4 | 42.0 |
| Far East | 14.1 | 2.1 | 0.7 | 0.4 | 17.3 |
| Middle East | 8.9 | 3.5 | – | – | 12.4 |
| Rest of World | 44.2 | 4.0 | – | 0.1 | 48.3 |
| **Total** | **302.7** | **185.2** | **78.6** | **71.6** | **638.1** |

(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 and Canada.

## Notes to the accounts for the year ended 31 December 2008

### 2. Segmental reporting *continued*

| | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|
| | Property | Energy | Marine | Aviation | Total |
| Outwards reinsurance premiums | (23.1) | (25.6) | (7.6) | (7.1) | (63.4) |
| Change in unearned premiums | (2.3) | 36.9 | (0.5) | 8.1 | 42.2 |
| Change in unearned premiums ceded | (5.1) | (5.3) | 0.1 | 0.7 | (9.6) |
| **Net premiums earned** | **272.2** | **191.2** | **70.6** | **73.3** | **607.3** |
| Insurance losses and loss adjustment expenses | (100.9) | (271.8) | (38.1) | (8.0) | (418.8) |
| Insurance losses recoverable | – | 43.3 | – | – | 43.3 |
| Insurance acquisition expenses | (35.3) | (36.7) | (19.8) | (15.1) | (106.9) |
| Insurance acquisition expenses ceded | 1.2 | 5.4 | 0.4 | 0.3 | 7.3 |
| **Net underwriting profit (loss)** | **137.2** | **(68.6)** | **13.1** | **50.5** | **132.2** |
| Unallocated income and expenses | | | | | (34.6) |
| **Profit before tax** | | | | | **97.6** |

| | Property | Energy | Marine | Aviation | Total |
|---|---|---|---|---|---|
| Loss ratio | 37.1% | 119.5% | 54.0% | 10.9% | 61.8% |
| Acquisition cost ratio | 12.5% | 16.4% | 27.5% | 20.2% | 16.4% |
| Expense ratio | – | – | – | – | 8.1% |
| **Combined ratio** | **49.6%** | **135.9%** | **81.5%** | **31.1%** | **86.3%** |

**Assets and liabilities by business segment – as at 31 December 2008**

| **Assets** | $m | $m | $m | $m | $m |
|---|---|---|---|---|---|
| | Property | Energy | Marine | Aviation | Total |
| Attributable to business segments | 108.3 | 102.9 | 40.8 | 55.3 | 307.3 |
| Other assets | | | | | 2,181.7 |
| **Total assets** | | | | | **2,489.0** |
| **Liabilities** | | | | | |
| Attributable to business segments | 281.2 | 430.1 | 111.6 | 67.0 | 889.9 |
| Other liabilities | | | | | 326.4 |
| **Total liabilities** | | | | | **1,216.3** |
| **Total net assets** | | | | | **1,272.7** |

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

**Notes to the accounts** for the year ended 31 December 2008

## 2. Segmental reporting *continued*

**Revenue and expense by business segment – for the year ended 31 December 2007**

| Gross premiums written | $m<br>Property | $m<br>Energy | $m<br>Marine | $m<br>Aviation | $m<br>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** |
| 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** |
| Unallocated income and expenses | | | | | 3.5 |
| **Profit before tax** | | | | | **391.9** |

| | 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%** |

**Assets and liabilities by business segment – as at 31 December 2007**

| Assets | $m<br>Property | $m<br>Energy | $m<br>Marine | $m<br>Aviation | $m<br>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** | | | | | |
| 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** |

(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 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 31 December 2008 and 2007.

## 3. Investment return

The total investment return for the Group is as follows:

| | 2008 $m | 2007 $m |
|---|---|---|
| Investment income | | |
| – Interest on fixed income securities | 46.5 | 60.0 |
| – Net amortisation of discount | 3.5 | 2.6 |
| – Interest income on cash and cash equivalents | 12.2 | 18.6 |
| – Dividends from equity securities | 0.9 | 0.8 |
| – Investment management and custodian fees | (3.6) | (3.6) |
| **Net investment income** | **59.5** | **78.4** |
| **Net realised and unrealised gains (losses) on other investments** | **0.1** | **(3.3)** |
| Net realised gains (losses) and impairments | | |
| – Fixed income securities | 10.6 | 5.0 |
| – Equity securities | (21.6) | 4.1 |
| **Net realised (losses) gains and impairments** | **(11.0)** | **9.1** |
| Net change in unrealised gains recognised in shareholders’ equity | | |
| – Fixed income securities | 16.5 | 9.2 |
| – Equity securities | (9.4) | 3.2 |
| **Net change in unrealised gains recognised in shareholders’ equity** | **7.1** | **12.4** |
| **Total investment return on available for sale investments** | **55.7** | **96.6** |
| **Net fair value (losses) gains on investments at fair value through profit and loss** | **(0.6)** | **0.4** |
| **Total investment return** | **55.1** | **97.0** |

Net realised gains and impairments on fixed income and equity securities includes an impairment loss of $21.6 million (2007 – $1.3 million) recognised on fixed income and equity investments held by the Group.

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

| | 2008 $m | 2007 $m |
|---|---|---|
| Fixed income securities | | |
| – Net unrealised gains released to income statement | (3.7) | (2.7) |
| – Net unrealised gains recorded within equity | 17.6 | 11.5 |
| – Net unrealised losses released for impairments to income statement | 2.6 | 0.4 |
| Equity securities | | |
| – Net unrealised gains released to income statement | (1.0) | (4.4) |
| – Net unrealised (losses) gains recorded within equity | (20.6) | 7.1 |
| – Net unrealised losses released for impairments to income statement | 12.2 | 0.5 |
| **Net unrealised gains recognised in shareholders’ equity** | **7.1** | **12.4** |

## Notes to the accounts for the year ended 31 December 2008

### 4. Net insurance acquisition expenses

| | 2008 $m | 2007 $m |
|---|---|---|
| Insurance acquisition expenses | 110.0 | 101.9 |
| Changes in deferred insurance acquisition expenses | (3.1) | (6.3) |
| Insurance acquisition expenses ceded | (6.1) | (19.7) |
| Changes in deferred insurance acquisition expenses ceded | (1.2) | 0.6 |
| **Total** | **99.6** | **76.5** |

### 5. Other operating expenses

| | 2008 $m | 2007 $m |
|---|---|---|
| Operating expenses unrelated to underwriting | 49.3 | 60.5 |
| Equity based compensation | 10.6 | 14.4 |
| **Total** | **59.9** | **74.9** |

### 6. Employee benefits

| | 2008 $m | 2007 $m |
|---|---|---|
| Wages and salaries | 14.2 | 12.8 |
| Pension costs | 1.2 | 0.9 |
| Bonus and other benefits | 9.6 | 23.1 |
| Equity based compensation | 10.6 | 14.4 |
| **Total** | **35.6** | **51.2** |

**Equity based compensation**

There are three forms of equity based compensation: warrants, a long-term incentive plan and a restricted share scheme.

On the admission of the Group's common shares to trading on AIM in December 2005, a pool of warrants to purchase common shares was created. Subsequently, a number of warrants were issued to certain members of management. The warrants that were issued to management were of two types: ordinary warrants and performance warrants. The unissued balance was reserved for future allocation. 648,143 ordinary warrants that had not been issued to management were subsequently issued to the Lancashire Foundation ("the Foundation") on 1 December 2007.

All warrants issued to management and the Foundation expire on 16 December 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 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 10 December 2007 and paid to shareholders of record on 11 January 2008.

## 6. Employee benefits *continued*

### Management team ordinary warrants ("ordinary warrants")

Ordinary warrants vest on a time basis only and 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.

| Ordinary warrants | Number | Weighted average exercise price US$ |
|---|---|---|
| **Outstanding as at 31 December 2006** | **12,708,695** | **$5.00** |
| Exercised during the year | (627,087) | $5.00 |
| Transferred during the year | (648,143) | $5.00 |
| **Outstanding as at 31 December 2007** | **11,433,465** | **$5.00** |
| **Outstanding as at 31 December 2008** | **11,433,465** | **$4.71** |
| **Exercisable as at 31 December 2008** | **11,433,465** | **$4.71** |

The fair value of ordinary warrants granted for all periods was $2.62 per share as there have been no further issues. A charge of $3.3 million (2007 – $7.1 million) for share-based payment is included in other operating expenses in the consolidated income statement.

### 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 31 December 2007, 31 December 2008 and 31 December 2009. A maximum of 50% of performance warrants will vest only on achievement of a fully converted 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.

| Performance warrants | Number | Weighted average exercise price US$ |
|---|---|---|
| **Outstanding as at 31 December 2006** | **7,236,331** | **$5.00** |
| Lapsed during the year | (761,985) | $5.00 |
| **Outstanding as at 31 December 2007** | **6,474,346** | **$5.00** |
| Lapsed during the year | (2,782,659) | $3.90 |
| **Outstanding as at 31 December 2008** | **3,691,687** | **$4.10** |
| **Exercisable as at 31 December 2008** | **839,994** | **$4.85** |

The fair value of warrants granted for all periods was $2.62 per share as there have been no further issues. A credit of $0.9 million (2007 – $2.2 million charge) for share-based payment is included in other operating expenses in the consolidated income statement.

## 6. Employee benefits *continued*

### Long-term incentive plan and restricted share scheme

Prior to 4 January 2008 share options could be granted under the long-term incentive plan ("LTIP") at the discretion of the Remuneration Committee. On 4 January 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, 16 December 2005. All LTIP options issued will expire ten years from the date of issue. The exercise price for LTIP 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.

### Long-term incentive plan

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

| | 31 December 2008 | | 31 December 2007 | |
|---|---|---|---|---|
| | Low | High | Low | High |
| | £2.69 | £2.99 | £3.25 | £3.55 |
| | $3.90 | $6.16 | $4.71[(1)] | $7.26 |

(1) Adjusted for revaluation at the exchange rate as at 31 December 2008

25% of LTIP 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.

The fair value of each LTIP 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 3.0% – 5.125%; an expected life of four to 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 | Weighted average exercise price US$ |
|---|---|---|
| **Outstanding as at 31 December 2006** | **2,401,943** | **$6.56** |
| Granted during the year | 4,590,105 | $7.04 |
| Forfeited during the year | (12,709) | $7.11 |
| **Outstanding as at 31 December 2007** | **6,979,339** | **$6.26[(1)]** |
| Forfeited during the year | (86,039) | $6.10 |
| **Outstanding as at 31 December 2008** | **6,893,300** | **$5.24** |
| **Exercisable as at 31 December 2008** | **2,157,899** | **$5.28** |

(1) Adjusted for revaluation at the exchange rate as at 31 December 2008

The weighted fair value of options granted during the year ended 31 December 2008 was $nil as there were no options granted during the year (2007 – $2.77). A share-based payment expense of $5.5 million (2007 – $5.1 million) is included in other operating expenses in the consolidated income statement.

On 4 January 2008 the LHL shareholders also voted in a Special General Meeting 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 14 February 2008 the Remuneration Committee 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 was $1.2 million and a $nil impact to shareholders' equity.

## 6. Employee benefits *continued*

### Restricted share scheme – ordinary

The Rules of the RSS approved by the shareholders permit the granting of restricted share awards subject to time and, normally, performance conditions. The ordinary restricted share awards vest after a three year period and are dependent on certain performance criteria. Awards were granted on 28 March and 1 July 2008. A maximum of 50% of ordinary restricted share awards will vest only on the achievement of a total shareholder return in excess of the 75th percentile of the total shareholder return of a pre-defined comparator group. A maximum of 50% of ordinary restricted share awards will vest only on the achievement of a return on equity by LHL in excess of a required amount.

| Ordinary restricted shares | Number | Fair value US$ |
|---|---|---|
| **Outstanding as at 31 December 2007** | **–** | **–** |
| Granted during the year | 1,851,701 | $5.75 |
| Forfeited during the year | (18,914) | $5.73 |
| **Outstanding as at 31 December 2008** | **1,832,787** | **$5.75** |
| **Exercisable as at 31 December 2008** | **–** | **–** |

The fair value of each restricted share granted pursuant to an ordinary restricted share award is equal to the share price of LHL on the date of grant. A share-based payment expense of $1.1 million is included in other operating expenses in the consolidated income statement.

### Restricted share scheme – exceptional

The exceptional restricted shares vest after a two year period and do not have associated performance criteria for vesting.

| Exceptional restricted shares | Number | Fair value US$ |
|---|---|---|
| **Outstanding as at 31 December 2007** | **–** | **–** |
| Granted during the year | 166,904 | $5.73 |
| **Outstanding as at 31 December 2008** | **166,904** | **$5.73** |
| **Exercisable as at 31 December 2008** | **–** | **–** |

The fair value of each restricted share granted pursuant to an exceptional restricted share award is equal to the share price of LHL on the date of grant. A share-based payment expense of $0.4 million is included in other operating expenses in the consolidated income statement.

## 7. Results of operating activities

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

| | 2008 $m | 2007 $m |
|---|---|---|
| Depreciation on owned assets | 1.1 | 1.4 |
| Operating lease charges | 1.8 | 1.8 |
| Auditors remuneration | | |
| – Group audit fees | 1.2 | 1.3 |
| – Other services | 0.2 | 0.2 |
| **Total** | **4.3** | **4.7** |

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

| | 2008 $m | 2007 $m |
|---|---|---|
| Tax advice | 0.1 | 0.1 |
| Other | 0.1 | 0.1 |
| **Total** | **0.2** | **0.2** |

## 8. Tax

### Bermuda

LHL, LICL and LUK have received an undertaking from the Bermuda government exempting them from all Bermuda local income, withholding and capital gains taxes until 28 March 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 | 2008 $m | 2007 $m |
|---|---|---|
| Corporation tax (credit) charge for the year | (0.3) | 2.1 |
| Adjustments in respect of prior year corporation tax | (0.4) | 0.1 |
| Deferred tax charge (credit) for the year | 0.3 | (1.1) |
| Adjustments in respect of prior year deferred tax | 0.5 | (0.1) |
| **Total** | **0.1** | **1.0** |

| Tax reconciliation | 2008 $m | 2007 $m |
|---|---|---|
| Profit before tax | 97.6 | 391.9 |
| Less profit not subject to tax | (101.9) | (389.0) |
| (Losses) profits subject to tax | (4.3) | 2.9 |
| UK corporation tax at weighted average rate | (1.2) | 0.9 |
| Adjustments in respect of prior period | 0.1 | – |
| Non-deductible expenses | – | 0.1 |
| Other expense temporary differences | 1.2 | (0.1) |
| Deferred tax at a rate other than weighted average rate | – | 0.1 |
| **Total** | **0.1** | **1.0** |

As at 1 April 2008 the standard rate of corporation tax in the UK is 28%. The weighted average rate for 2008 is 28.5%. For all previous periods the standard rate and the weighted average rate was 30%. The current tax charge as a percentage of the Group's profit before tax is 0.1% (2007 – 0.3%) due to the different tax paying jurisdictions throughout the Group.

A current corporation tax expense of $0.2 million was charged to shareholders' equity during the year (2007 – $0.4 million), which relates to unrealised investment gains and losses recognised directly in fair value and other reserves within shareholders' equity.

| Taxation | 2008 $m | 2007 $m |
|---|---|---|
| UK corporation tax payable | – | 1.2 |

**Notes to the accounts** for the year ended 31 December 2008

## 9. Deferred tax

| | 2008 $m | 2007 $m |
|---|---|---|
| Deferred tax assets | 2.4 | 2.0 |
| Deferred tax liabilities | (1.2) | – |
| **Net deferred tax asset** | **1.2** | **2.0** |

Deferred tax assets are recognised to the extent that realising the related tax benefit through future taxable profits is likely. It is anticipated that the Lancashire UK group of companies will be profitable in 2009, thus the entire deferred tax asset is recognised.

The deferred tax asset relates to the warrants, options and restricted stock employee benefit schemes and tax losses carried forward. The deferred tax liability relates to claims equalisation reserves. All deferred tax assets and liabilities are classified as non-current.

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

| | 2008 $m | 2007 $m |
|---|---|---|
| As at 1 January | 2.0 | 0.8 |
| Income statement (charge) credit | (0.8) | 1.2 |
| **As at 31 December** | **1.2** | **2.0** |

## 10. Cash and cash equivalents

| | 2008 $m | 2007 $m |
|---|---|---|
| Cash at bank and in hand | 7.9 | 22.8 |
| Cash equivalents | 405.7 | 714.5 |
| **Total** | **413.6** | **737.3** |

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 totalling $24.5 million (2007 – $22.1 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 totalling $37.7 million (2007 – $36.9 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.

Cash and cash equivalents totalling $2.8 million (2007 – $nil) were on deposit as collateral for the benefit of the counter-party to the interest rate swaps.

## Notes to the accounts for the year ended 31 December 2008

### 11. Investments

| As at 31 December 2008 | $m<br>Cost or amortised cost | $m<br>Gross unrealised gain | $m<br>Gross unrealised loss | $m<br>Estimated fair value |
|---|---|---|---|---|
| Fixed income securities | | | | |
| – Short-term investments | 163.6 | – | – | 163.6 |
| – U.S. treasuries | 186.8 | 6.5 | (1.6) | 191.7 |
| – Other government bonds | 52.5 | 1.6 | – | 54.1 |
| – U.S. government agency debt | 109.1 | 5.4 | – | 114.5 |
| – U.S. government agency mortgage backed securities | 600.0 | 15.3 | (0.9) | 614.4 |
| – Corporate bonds | 306.6 | 3.8 | (6.9) | 303.5 |
| – Corporate bonds – FDIC guaranteed(1) | 148.4 | 5.0 | – | 153.4 |
| – Convertible debt securities | 0.2 | – | – | 0.2 |
| **Total fixed income securities – available for sale** | **1,567.2** | **37.6** | **(9.4)** | **1,595.4** |
| Equity securities – available for sale | 5.8 | – | – | 5.8 |
| **Total available for sale securities** | **1,573.0** | **37.6** | **(9.4)** | **1,601.2** |
| Fixed income securities – at fair value through profit and loss | 4.3 | – | (0.3) | 4.0 |
| **Total investments** | **1,577.3** | **37.6** | **(9.7)** | **1,605.2** |

(1) FDIC guaranteed corporate bonds are protected by the Federal Deposit Insurance Corporation, an independent agency of the United States government.

| As at 31 December 2007 | $m<br>Cost or amortised cost | $m<br>Gross unrealised gain | $m<br>Gross unrealised loss | $m<br>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 profit and loss | 23.1 | 0.8 | (0.4) | 23.5 |
| Other investments – at fair value through profit and loss (note 20) | 4.4 | 0.4 | (0.4) | 4.4 |
| **Total investments** | **1,147.7** | **26.8** | **(5.3)** | **1,169.2** |

Equity securities and other investments are deemed non-current. Fixed income maturities are presented in the risk disclosures section on page 75.

**Notes to the accounts** for the year ended 31 December 2008

## 12. Investment in associate

On 15 June 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"), was authorised as a Class 3 insurer by the BMA. Sirocco Re was established to assume Gulf of Mexico energy risks from the Group. Effective 31 December 2007, the reinsurance agreement entered into with Sirocco Re was commuted. Sirocco entered into a members' voluntary liquidation on 12 June 2008 and was dissolved on 17 September 2008.

| | 2008 $m | 2007 $m |
|---|---|---|
| As at 1 January | 22.9 | 23.2 |
| Share of (loss) profit of associate | (0.2) | 6.2 |
| Dividends received | (22.7) | (6.5) |
| **As at 31 December** | **–** | **22.9** |

Key financial information for Sirocco for the years ended 31 December 2008 and 2007 is as follows:

| | 2008 $m | 2007 $m |
|---|---|---|
| Assets | – | 117.0 |
| Liabilities | – | 8.2 |
| Shareholders' equity | – | 108.8 |
| Revenues | – | 36.4 |
| (Loss) profit | (1.5) | 29.8 |

## 13. Insurance and reinsurance contracts

| **Insurance liabilities** | $m | $m | $m |
|---|---|---|---|
| | **Unearned premiums** | **Other payables** | **Total** |
| **As at 31 December 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 31 December 2007** | **381.8** | **16.5** | **398.3** |
| Net deferral for: | | | |
| Prior years | (317.5) | – | (317.5) |
| Current year | 275.3 | – | 275.3 |
| Other | – | 1.1 | 1.1 |
| **As at 31 December 2008** | **339.6** | **17.6** | **357.2** |

**Notes to the accounts** for the year ended 31 December 2008

## 13. Insurance and reinsurance contracts *continued*

| Losses and loss adjustment expenses | $m | $m | $m |
|---|---|---|---|
| | Losses and loss adjustment expenses | Reinsurance recoveries | Net losses and loss adjustment expenses |
| **As at 31 December 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 31 December 2007** | **179.6** | **(3.6)** | **176.0** |
| Net incurred losses for: | | | |
| Prior years | (26.0) | (2.6) | (28.6) |
| Current year | 444.8 | (40.7) | 404.1 |
| Exchange adjustments | (0.5) | – | (0.5) |
| **Incurred losses and loss adjustment expenses** | **418.3** | **(43.3)** | **375.0** |
| Net paid losses for: | | | |
| Prior years | 34.6 | (0.4) | 34.2 |
| Current year | 34.5 | (4.4) | 30.1 |
| **Paid losses and loss adjustment expenses** | **69.1** | **(4.8)** | **64.3** |
| **As at 31 December 2008** | **528.8** | **(42.1)** | **486.7** |

**Notes to the accounts** for the year ended 31 December 2008

## 13. Insurance and reinsurance contracts *continued*

| Reinsurance assets and liabilities | $m | $m | $m | $m |
|---|---|---|---|---|
| | Unearned premiums on premium ceded | Amounts payable to reinsurers | Other receivables | Total |
| **As at 31 December 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 31 December 2007** | **19.6** | **(5.7)** | **8.2** | **22.1** |
| Net deferral for: | | | | |
| Prior years | (18.6) | – | – | (18.6) |
| Current year | 9.0 | – | – | 9.0 |
| Other | – | 3.7 | (5.0) | (1.3) |
| **As at 31 December 2008** | **10.0** | **(2.0)** | **3.2** | **11.2** |

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 70. The risks associated with general insurance contracts are complex and do not readily lend themselves to meaningful sensitivity analysis. The impact of an unreported event could lead to a significant increase in our loss reserves. The Group believes that the loss reserves established are adequate, however a 20% increase in estimated losses would lead to a $105.8 million (2007 – $35.9 million) increase in loss reserves. There was no change to reserving assumptions during the year.

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

| | 2008 $m | 2007 $m |
|---|---|---|
| Outstanding losses | 303.4 | 56.0 |
| Additional case reserves | 63.8 | 17.8 |
| Losses incurred but not reported | 161.6 | 105.8 |
| **Losses and loss adjustment expenses** | **528.8** | **179.6** |

It is estimated that our reserve for unpaid losses and loss adjustment expenses has a duration of approximately two years.

## 13. Insurance and reinsurance contracts *continued*

### 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 31 December 2005, the Group does not expect to incur any losses from coverage provided in 2005. Accordingly, the loss development tables do not include that year.

| Accident year | 2006 $m | 2007 $m | 2008 $m |
|---|---|---|---|
| **Gross claims** | | | |
| Estimate of ultimate liability[1] | | | |
| At end of accident year | 39.1 | 154.8 | 444.6 |
| One year later | 34.7 | 131.2 | – |
| Two years later | 32.0 | – | – |
| **Current estimate of cumulative liability** | **32.0** | **131.2** | **444.6** |
| **Payments made** | **(18.8)** | **(25.7)** | **(34.5)** |
| **Total gross liability** | **13.2** | **105.5** | **410.1** |

| Accident year | 2006 $m | 2007 $m | 2008 $m |
|---|---|---|---|
| **Reinsurance** | | | |
| Estimate of ultimate recovery[1] | | | |
| At end of accident year | – | 3.6 | 40.7 |
| One year later | – | 6.2 | – |
| Two years later | – | – | – |
| **Current estimate of cumulative recovery** | **–** | **6.2** | **40.7** |
| **Payments received** | **–** | **(0.4)** | **(4.4)** |
| **Total gross recovery** | **–** | **5.8** | **36.3** |

| Accident year | 2006 $m | 2007 $m | 2008 $m |
|---|---|---|---|
| **Net claims** | | | |
| Estimate of net ultimate liability[1] | | | |
| At end of accident year | 39.1 | 151.2 | 403.9 |
| One year later | 34.7 | 125.0 | – |
| Two years later | 32.0 | – | – |
| **Current estimate of net cumulative liability** | **32.0** | **125.0** | **403.9** |
| **Payments made** | **(18.8)** | **(25.3)** | **(30.1)** |
| **Total net liability** | **13.2** | **99.7** | **373.8** |

(1) Adjusted for revaluation of foreign currencies at the exchange rate as at 31 December 2008.

## 13. Insurance and reinsurance contracts *continued*

The inherent uncertainty in reserving gives rise to favourable or adverse development on the established reserves. The total favourable development on net losses and loss adjustment expenses from prior years was $28.6 million (2007 – $4.4 million) with $26.0 million (2007 – $nil) from the 2007 accident year and $2.6 million (2007 – $4.4 million) from the 2006 accident year.

Prior to the hurricane season of 2008 there were no major loss events that impacted the Group's losses and loss adjustment expenses. During the 2008 hurricane season, Hurricanes Gustav and Ike passed through the Gulf of Mexico oil fields, making landfall in the United States. Hurricane Ike was a particularly destructive storm, causing damage to and destruction of a significant number of oil platforms. $172.7 million, before tax, in relation to Hurricanes Gustav and Ike is included within the Group's net insurance losses with $206.7 million in losses and loss adjustment expenses and $34.0 million in losses and loss adjustment expenses recoverable. Reinstatement premium of $8.9 million was earned as a result of these losses. The impact of tax and other adjustments brings the overall net financial impact to the Group to $152.9 million. Estimation of the ultimate liability is complex for offshore losses. Loss assessments require skilled loss adjusters. The availability of loss adjusters with the necessary expertise is scarce and large events put a further strain on this resource. A substantial degree of judgement is involved in assessing the ultimate cost of Hurricanes Gustav and Ike and the amount could be materially different from that currently reported. Management's best estimate of losses and loss adjustment expenses, net of reinsurance and reinstatement premiums but before taxes and other adjustments, for Hurricanes Gustav and Ike is $163.8 million. Using a lognormal distribution with a standard deviation of $25.0 million a confidence interval was derived around the best estimate. The 90th percentile of this distribution is $196.9 million, which would be an increase of $33.1 million over the current best estimate. The 95th percentile is $208.0 million, or an increase of $44.2 million.

## 14. Insurance, reinsurance and other receivables

| | 2008 $m | 2007 $m |
|---|---|---|
| Accrued interest receivable | 10.1 | 9.8 |
| Reinsurance assets | | |
| – Reinsurance recoveries | 42.1 | 3.6 |
| – Other receivables | 3.2 | 8.2 |
| Other receivables | 154.0 | 3.8 |
| Inwards premium receivable from insureds and cedants | 187.3 | 198.2 |
| **Total receivables** | **396.7** | **223.6** |

Other receivables consist primarily of unsettled investment trades. All receivables are considered current other than $24.0 million (2007 – $10.6 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 31 December 2006** | **51.5** |
| Net deferral during the year | 101.9 |
| Expense incurred for the year | (95.6) |
| **As at 31 December 2007** | **57.8** |
| Net deferral during the year | 110.0 |
| Expense incurred for the year | (106.9) |
| **As at 31 December 2008** | **60.9** |

## 16. Insurance, reinsurance and other payables

| | 2008 $m | 2007 $m |
|---|---|---|
| Dividends payable | – | 239.1 |
| Other payables | 190.3 | 57.1 |
| **Total other payables** | **190.3** | **296.2** |
| Insurance contracts – other payables | 17.6 | 16.5 |
| Amounts payable to reinsurers | 2.0 | 5.7 |
| **Total payables** | **209.9** | **318.4** |

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 31 December 2006** | **2.5** |
| Net deferral during the year | 19.7 |
| Income recognised for the year | (19.1) |
| **As at 31 December 2007** | **3.1** |
| Net deferral during the year | 6.1 |
| Income recognised for the year | (7.3) |
| **As at 31 December 2008** | **1.9** |

## 18. Property, plant and equipment

| | $m | $m | $m | $m |
|---|---|---|---|---|
| | Office furniture and equipment | Leasehold improve-ments | IT equipment | Total |
| **Cost** | | | | |
| **As at 31 December 2006** | **1.0** | **0.6** | **1.4** | **3.0** |
| Additions | 0.5 | 0.6 | 0.2 | 1.3 |
| **As at 31 December 2007** | **1.5** | **1.2** | **1.6** | **4.3** |
| Additions | 0.1 | – | 0.1 | 0.2 |
| **As at 31 December 2008** | **1.6** | **1.2** | **1.7** | **4.5** |
| **Accumulated depreciation** | | | | |
| **As at 31 December 2006** | **0.2** | **0.1** | **0.3** | **0.6** |
| Charge for the year | 0.7 | 0.2 | 0.5 | 1.4 |
| **As at 31 December 2007** | **0.9** | **0.3** | **0.8** | **2.0** |
| Charge for the year | 0.3 | 0.3 | 0.5 | 1.1 |
| **As at 31 December 2008** | **1.2** | **0.6** | **1.3** | **3.1** |
| **Net book value** | | | | |
| **As at 31 December 2007** | **0.6** | **0.9** | **0.8** | **2.3** |
| **As at 31 December 2008** | **0.4** | **0.6** | **0.4** | **1.4** |

## 19. Long-term debt and financing arrangements

| | 2008 $m | 2007 $m |
|---|---|---|
| Subordinated loan note of $97.0 million | 97.0 | 97.0 |
| Subordinated loan note of €24.0 million | 33.8 | 35.3 |
| **Carrying value and fair value** | **130.8** | **132.3** |

On 15 December 2005 the Group issued, via a trust company, $97.0 million in aggregate principal amount of subordinated loan notes and €24.0 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 15 December 2035 with a prepayment option available from 15 March 2011. Prior to 15 March 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 15 June 2035 with a prepayment option available from 15 March 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 73.

The interest accrued on the loans payable was $0.4 million (2007 – $0.5 million) at the balance sheet date. The interest expense for the year was $9.8 million (2007 – $11.6 million).

## 19. Long-term debt and financing arrangements *continued*

### Letters of credit

As both LICL and LUK are non-admitted insurers or reinsurers throughout the U.S., the terms of certain contracts require them to provide letters of credit to policyholders as collateral. On 16 July 2007, LHL and LICL re-financed its syndicated collateralised credit facility in the amount of $200.0 million for a five year term. 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 LUK to collateralise certain insurance balances. As at 31 December 2008, letters of credit totalling $61.9 million had been issued to LUK (2007 – $61.9 million). Letters of credit totalling $26.7 million (2007 – $37.0 million) had been issued to third parties by LICL and there was no outstanding debt under this facility (2007 – $nil). Letters of credit are required to be fully collateralised. As at 31 December 2008 $118.0 million (2007 – $110.8 million) of collateral had been posted to a trust account, the beneficiaries of which are the banks who have issued letters of credit on LICL's 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 and for the years ended 31 December 2008 and 2007 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 profit and loss. During the year, $3.6 million (2007 – $1.3 million) was charged to financing costs in respect of the interest rate swap. The net fair value position owed by the Group was $4.9 million (2007 – $2.2 million). The Group has the right to net settle these instruments. The next cash settlement due on these instruments is $0.5 million (2007 – negligible) and is due on 15 March 2009. The counter-party requires collateralisation of positions in excess of $2.0 million. These instruments will expire on 15 March 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 at fair value through profit and loss. As at 31 December 2008 the derivative instrument was valued at $nil (2007 – $4.4 million), with changes in net realised gains of $0.1 million (2007 – $1.8 million change in net unrealised losses) reflected in the consolidated income statement in other investment income (losses).

The Group occasionally invests in mortgage backed "to be announced" securities. These instruments may be physically settled or net settled. Net settled instruments are deemed to be derivatives with changes in estimated fair value recognised in current period income. As at 31 December 2008 and 2007 the Group did not hold any such instruments and no realised gains or losses were recorded in the consolidated income statement.

The Group entered into a contingent equity physically settled put option on 13 June 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 30 November 2007. There was no obligation to exercise the option. During 2007 $1.1 million was charged to financing costs in respect of the option, and $1.5 million was charged to other investment income (losses) in respect of the value of the derivative at inception of the contract which expired unexercised.

**Notes to the accounts** for the year ended 31 December 2008

## 21. Share capital

| Authorised ordinary shares of $0.50 each | Number | $m |
|---|---|---|
| **As at 31 December 2008 and 2007** | **3,000,000,000** | **1,500** |

| Allocated, called up and fully paid | | |
|---|---|---|
| **As at 31 December 2006** | **195,743,346** | **97.9** |
| Shares issued | 627,087 | 0.1 |
| Shares repurchased | (14,087,338) | (6.9) |
| **As at 31 December 2007** | **182,283,095** | **91.1** |
| Shares repurchased | (9,433,168) | – |
| **As at 31 December 2008** | **172,849,927** | **91.1** |

On 15 May 2007, 127,087 shares were issued and 94,447 repurchased as part of a cashless exercise of warrants (see note 22).
On 15 August 2007, 500,000 shares were issued and 351,975 repurchased as part of a cashless exercise of warrants (see note 22).

The Board of Directors granted share repurchase authorisations as follows:

| Date | authorisation $m |
|---|---|
| 29 October 2007 | 100.0 |
| 30 April 2008 | 25.0 |
| 9 June 2008 | 25.0 |
| 1 July 2008 | 25.0 |
| **Total** | **175.0** |

An amount of $17.0 million of approved repurchase remains in place under the current authorisations.

To date, shares have been repurchased as follows:

| Date | Number of shares | Weighted average share price | $m |
|---|---|---|---|
| 9 November – 18 December 2007[(1)(2)] | 13,640,916 | £3.54 | 100.2 |
| 12 May – 10 June 2008[(3)] | 3,965,590 | £3.19 | 25.0 |
| 13 June – 13 August 2008[(3)] | 4,143,657 | £3.05 | 25.0 |
| 13 August – 29 August 2008[(3)] | 1,323,921 | £3.24 | 8.0 |
| **Total** | **23,074,084** | **£3.37** | **158.2** |

(1) Due to the movement of exchange rates between trade and settlement dates, the amount paid for the $100.0 million share repurchase programme was $100.2 million versus the authorised programme of $100.0 million. The variance was ratified by the Board of Directors on 14 February 2008.
(2) These shares were repurchased and cancelled.
(3) These shares were repurchased and transferred to treasury shares.

**Notes to the accounts** for the year ended 31 December 2008

## 21. Share capital *continued*

Shares were repurchased from significant founding shareholders as follows:

(i) On 9 November 2007 the Group repurchased 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").
(ii) On 15 November 2007 the Group repurchased 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").

At the balance sheet date $0.2 million (2007 – $10.5 million) was yet to be settled.

On 10 December 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 11 January 2008 with a settlement date of 25 January 2008. The total dividend amount payable was $239.1 million and was recorded in other payables in the consolidated balance sheet.

## 22. Warrants, options and restricted shares

| Warrants | Number | Number | Number | Number |
|---|---|---|---|---|
| | Founders' warrants | Founders' warrants | Management performance warrants | Management performance warrants |
| **Outstanding as at 31 December 2006** | **25,303,917** | **–** | **12,708,695** | **7,625,218** |
| Exercised | – | – | (627,087) | – |
| Lapsed | – | – | – | (802,935) |
| Transferred | – | 648,143 | (648,143) | – |
| **Outstanding as at 31 December 2007** | **25,303,917** | **648,143** | **11,433,465** | **6,822,283** |
| Lapsed | – | – | – | (2,932,201) |
| **Outstanding as at 31 December 2008** | **25,303,917** | **648,143** | **11,433,465** | **3,890,082** |
| **Exercisable as at 31 December 2008** | **25,303,917** | **648,143** | **11,433,465** | **839,994** |

| Options and restricted shares | Number | Number | Number |
|---|---|---|---|
| | Options | Ordinary restricted shares | Exceptional restricted shares |
| **Outstanding as at 31 December 2006** | **2,401,943** | **–** | **–** |
| Issued | 4,590,105 | – | – |
| Forfeited | (12,709) | – | – |
| **Outstanding as at 31 December 2007** | **6,979,339** | **–** | **–** |
| Issued | – | 1,851,701 | 166,904 |
| Forfeited | (86,039) | (18,914) | – |
| **Outstanding as at 31 December 2008** | **6,893,300** | **1,832,787** | **166,904** |
| **Exercisable as at 31 December 2008** | **2,157,899** | **–** | **–** |

## 22. Warrants, options and restricted shares *continued*

All warrants issued will expire on 16 December 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 on 16 December 2005. 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. 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 10 December 2007 and paid to shareholders of record on 11 January 2008.

Founders' warrants issued in 2005 were issued to the Group's founders' for providing expertise, resources and relationships during the Group's incorporation, and to one of the Group's sponsors for incorporation services. These warrants were fully vested at the date of grant and exercisable upon issuance. In 2006 the sponsor holding founders' warrants sold its entire holding of warrants to an unrelated third party. The weighted average exercise price for all founders' warrants at 31 December 2008 is $5.00.

In December 2007 allocated but unissued ordinary time-vesting warrants were issued to the Foundation, a charity established under Bermuda Law. Refer to note 25 for additional information on the Foundation. These ordinary time-vesting warrants were issued from the ordinary warrants that remained allocated but unissued to management. As at 31 December 2008 these warrants are fully vested and exercisable. The weighted average exercise price for the foundation warrants is $4.73.

Management warrants, options and restricted shares are discussed in note 6. Included in the table above are 198,395 (2007 – 347,937) management performance warrants that remain unallocated.

## 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 (2007 – $1.8 million). Future minimum lease payments under non-cancellable operating leases are as follows:

| | 2008 $m | 2007 $m |
|---|---|---|
| Due in less than one year | 1.7 | 1.9 |
| Due between one and five years | 6.7 | 2.3 |
| **Total** | **8.4** | **4.2** |

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 completion of construction. The lease obligations as currently drafted are included in the table above.

## 24. Earnings per share

Basic earnings per share amounts are calculated by dividing net profit for the year 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 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.

**Notes to the accounts** for the year ended 31 December 2008

## 24. Earnings per share *continued*

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

| | 2008 $m | 2007 $m |
|---|---|---|
| Profit for the year attributable to equity shareholders | 97.5 | 390.9 |

| | Number of shares thousands | Number of shares thousands |
|---|---|---|
| Basic weighted average number of shares | 177,468 | 194,201 |
| Potentially dilutive shares related to share-based compensation | 7,683 | 10,959 |
| Diluted weighted average number of shares | 185,151 | 205,160 |

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 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. Unvested restricted shares without performance criteria are also included in the number of potentially dilutive shares.

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

## 25. Related party disclosures

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

| Name | Domicile |
|---|---|
| Lancashire Insurance Company Limited | Bermuda |
| Lancashire Insurance Marketing Services Limited | United Kingdom |
| Lancashire Holdings Financing Trust I | United States |
| Lancashire Holdings Employee Benefit Trust | Jersey |
| 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 the 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.

On 14 February 2008 the Group established the Lancashire Holdings Employee Benefit Trust (the "EBT") to assist in the administration of the Group's employee equity based compensation schemes. The EBT did not undertake any transactions during 2008. While the Group does not have legal ownership of the EBT, and the ability of the Group to influence the actions of the EBT is limited by the Trust Deed, the EBT was set up by the Group with the sole purpose of assisting in the administration of these schemes and is, in essence, controlled by the Group, and is therefore consolidated.

## 25. Related party disclosures *continued*

### Key management compensation

Remuneration for key management (meaning the Group's three executive directors) for the year ending 31 December was as follows:

| | 2008 $m | 2007 $m |
|---|---|---|
| Short-term compensation | 5.3 | 11.3 |
| Equity based compensation | 5.8 | 10.8 |
| **Total** | **11.1** | **22.1** |

### Transactions with directors and shareholders

Significant shareholders have a representation on the Board of Directors. During the year the Group paid $1.8 million (2007 – $1.2 million) in directors' fees and expenses, including $0.7 million (2007 – $0.5 million) to directors representing significant shareholders. A further $0.2 million (2007 – $0.2 million) was paid in respect of monitoring fees for significant founding shareholders.

### Transactions with associate

There was no cession to Sirocco Re during 2008. During 2007 the Group ceded $25.1 million of premium to Sirocco Re and received $11.6 million of commission income. As at 31 December 2007 $8.2 million was included in reinsurance assets – other receivables in the consolidated balance sheet. The final profit commission of $7.8 million was included in other receivables of $8.2 million.

### Transactions with Lancashire Foundation

On 1 December 2007 648,143 warrants were allocated to the Foundation. As a result the initial funding of the Foundation was achieved with no impact on LHL's return on equity.

As at 31 December 2007 LHL had loaned the Foundation $0.4 million 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. Subsequent to 31 December 2007 the loan was repaid in full.

On 30 April 2008 the Board of Directors approved a cash donation of $1.0 million (2007 – $nil) to the Foundation.

## 26. Non-cash transactions

Available for sale mortgage backed to be announced security purchases and sales of $223.2 million and $228.4 million respectively were net settled during the year through the use of derivative instruments.

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

**Notes to the accounts** for the year ended 31 December 2008

## 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 31 December 2008 | $m | £m |
|---|---|---|
| | LICL | LUK |
| Statutory capital and surplus | 1,080.1 | 125.1 |
| Minimum required statutory capital and surplus | 256.8 | 22.7 |

| As at 31 December 2007 | $m | £m |
|---|---|---|
| | LICL | LUK |
| Statutory capital and surplus | 1,387.1 | 55.4 |
| Minimum required statutory capital and surplus | 311.1 | 13.4 |

For LUK, various capital calculations are performed and an individual assessment of LUK'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 to maintain a minimum liquidity ratio, whereby relevant assets, as defined in the regulations, must exceed 75% of relevant liabilities. As at 31 December 2008 and 2007 the liquidity ratio was met. LICL is also required to perform various capital calculations under the BMA's regulatory framework. An assessment is made of LICL's capital needs and a target capital amount is determined. The BMA may require a further capital loading on the target capital amount in certain circumstances. The BMA considers that a decrease in capital below the target level represents a regulatory intervention point.

As at 31 December 2008 and 2007 the regulatory capital requirements of all three jurisdictions in which the Group has operating subsidiaries were met.

## 28. Presentation

Certain amounts in the 31 December 2007 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 Holdings Limited, Mintflower Place, 8 Par-la-Ville Road, Hamilton HM 08, Bermuda, Tel: + 1 441 278 8950 and email: greg.lunn@lancashiregroup.com

## Further information

Lancashire Holdings Limited is registered in Bermuda under company number EC 37415 and has its registered office at Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda.

Further information about the Group including this annual report, press releases and the Company's share price is available on our website at www.lancashiregroup.com. Please address any enquiries to info@lancashiregroup.com.

# 107 ~ Note regarding forward-looking statements

Certain statements and indicative projections made that are not based on current or historical facts are forward-looking in nature including without limitation, statements containing words “believes”, “anticipates”, “plans”, “projects”, “intends”, “expects”, “estimates”, “predicts”, “may”, “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, business strategy, plans and objectives of management for future operations (including development plans and objectives relating to the Group’s insurance business) are forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of the Group to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. These factors include, but are not limited to: the number and type of insurance and reinsurance contracts that 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; 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.

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 Listing Rules of the Financial Services Authority)) 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.

Some of the statements in this document include forward-looking statements which reflect the Directors’ current views with respect to financial performance, business strategy, plans and objectives of management for future operations (including development plans relating to the Group’s products and services). These statements include forward-looking statements both with respect to the Group and the sectors and industries in which the Group operates. Statements which include the words “believes”, “anticipates”, “plans”, “projects”, “intends”, “expects”, “estimates”, “predicts”, “may”, “will”, “seeks”, “should” or, in each case, their negative or comparable terminology and similar statements are of a future or forward-looking nature. All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause the Group’s actual results to differ materially from those indicated in these statements. These factors include but are not limited to those described in the part of this document entitled “Risk Factors”, which should be read in conjunction with the other cautionary statements that are included in this document. Any forward-looking statements in this document reflect the Directors’ current views with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to the Group’s operations, results of operations, growth strategy and liquidity. Given these uncertainties investors are cautioned not to place any undue reliance on such forward-looking statements.

These forward-looking statements speak only as of the date of this document. Subject to any obligations under the Prospectus Rules, the Listing Rules, the Disclosure and Transparency Rules or as otherwise required by law, the Company undertakes no obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise. All subsequent written and oral forward-looking statements attributable to the Group or individuals acting on behalf of the Group are expressly qualified in their entirety by this paragraph. Prospective investors should specifically consider the factors identified in this document which could cause actual results to differ before making an investment decision.

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