Lancashire
Holdings Limited

Solvency & Financial Condition Report 2018

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SUMMARY

This executive summary outlines material changes over the reporting period. Note that due to the different presentation bases between IFRS and Solvency II in a number of areas including: the treatment of the Cathedral subsidiaries; the calculation of insurance technical provisions; the eligibility of Own Funds; and line of business segmentation, amongst others, the numbers presented in this report are not always directly comparable to those published in LHL's Annual Report and Accounts as at 31 December 2018.

During 2018, the Group reviewed the location of it's Group supervision with a view to better alignment with its strategic priorities. With effect from 1 January 2019 LHL has become group supervised by the BMA, and tax resident in Bermuda. Although the Group will be supervised by the BMA from 1 January 2019 it is required to meet PRA Solvency II reporting and disclosure requirements in full for the year ended 31 December 2018. A waiver was granted by the PRA in March 2019 exempting the relevant elements of LHL's SFCR from external audit requirements for 31 December 2018.

Business and performance

The Lancashire Group is a provider of specialty, short-tail insurance and reinsurance operating across three platforms: Lancashire, Cathedral and Kinesis. For the purposes of Solvency II reporting, Cathedral and Kinesis are included in Lancashire's Group results as related undertakings. This report therefore focuses on the Lancashire platform, which consists of two operating companies covering the London and Bermuda markets across five Solvency II lines of business: marine, aviation and transport insurance; fire and other damage to property insurance; credit and suretyship; non-proportional property reinsurance; and non-proportional marine, aviation and transport reinsurance. There have been no significant strategic changes in the Group's business during 2018.

2018 has once again been an active year with loss quantum being significantly above historical averages, with a high frequency of losses from both natural catastrophe and man-made events. Natural catastrophe losses included the wildfires in California, typhoons in Japan, the Philippines and China and hurricanes in the U.S.. 2018 has also seen a sharp increase in man-made losses, with significant loss activity on classes such as downstream energy and marine. Our gross loss ratio was 37.4% (18.9% on a net basis).

Following the record loss events of 2017 the direction of premium rate change, for the first time in five years, has moved positively. Net premiums earned were $247,073 thousand and we were able to produce an underwriting profit of $114,846 thousand.

Net investment income excluding realised and unrealised gains and losses was $29,873 thousand and total investment return was $8,241 thousand. The return was driven by the positive returns on the Group's standard fixed maturity portfolios as coupon returns more than offset the increase in treasury yields and widening of credit spreads that took place in 2018.

System of governance

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

Good strategic debate and decision making remain central to the work of any board. At Lancashire we are fortunate in having a nimble strategy and a simple 'flat' structure with a total employee headcount at 31 December 2018 of 218. This means that all our Directors have regular opportunities to meet with both the members of our management team and other employees within the business. That helps inform our Board's active understanding of the business, its needs and challenges.

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

As a premium-listed company on the LSE, Lancashire measures its corporate governance compliance against the requirements of the UK Corporate Governance Code published by the UK FRC. The Company has a robust Board and Committee structure. The Board has established Audit, Investment, Nomination and Corporate Governance, Underwriting and Underwriting Risk and Remuneration Committees. Certain matters are reserved for the Board such as strategy, internal controls and risk. Details of Board Committees and key functions are provided in section B.1. There have been no changes to the Company's governance structure during the year.

Risk profile

The Group is exposed to risks from several sources. These include insurance risk, market risk, liquidity risk, credit risk, operational risk and strategic risk. The primary risk to the Group is insurance risk. There were no changes to the Group's key risk areas in 2018. Each of these risk areas is described in more detail in section C below.

Valuation for solvency purposes

Apart from some balance sheet reclassifications and valuation adjustments required for determining reinsurance recoverables and technical provisions, and long-term debt there are no differences between the bases, methods and main assumptions used in valuing assets and liabilities for Solvency II purposes compared to those used in LHL's consolidated IFRS financial statements that are prepared in accordance with accounting principles generally accepted under IFRS as adopted by the EU. However, the Cathedral companies are not fully consolidated on a line-by-line basis, which is different from their IFRS treatment; their Solvency II net asset value is included in the Group's balance sheet as a 'holding in related undertaking'. This treatment of the Group's investment in the Cathedral group of companies, using the adjusted equity method for Solvency II purposes, results in there being no recognition of intangible assets on the Group's balance sheet as well as there being significant differences between most of the Group's individual balance sheet line items on a Solvency II basis compared to an IFRS basis.

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

Detailed explanations and reconciliations from the assets and liabilities presented in the LHL's consolidated IFRS financial statements as at 31 December 2018 to those presented on a Solvency II basis in this report are included in Section D below. There were no significant changes to the Group's Solvency II valuation methodology during 2018.

Capital management

Lancashire has built a reputation for being one of the best known and most active proponents of capital management in the industry. Capital management is our most important area of focus after underwriting and it is our firm belief that proactive and flexible capital management is crucial in helping to generate a superior risk-adjusted return over time. With our focus on maximising risk-adjusted shareholder return across the cycle, we will return capital where this offers the best returns for our shareholders. We have returned 109.9% of comprehensive income (loss) generated via dividends or share repurchases since inception.

The Group actively reviews the level and composition of capital on an ongoing basis. Internal methods have been developed to review the profitability of classes of business and their estimated capital requirements plus the capital requirements of the combination of a wide range of other risk categories.

The key aim of the capital management process is to maintain a strong balance sheet, whilst:

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

Of the Group's Own Funds, totalling $662,906 thousand as at 31 December 2018, 99.8% comprised Tier 1 capital items. Tier 1 capital is the highest quality capital under Solvency II with the greatest loss absorbing capacity, comprising share capital and retained earnings. There have been no changes to the profile of the components of the Group's Own Funds during the year ended 31 December 2018.

The Group uses the standard formula to calculate its SCR which amounted to $535,061 thousand at 31 December 2018. The SCR, analysed by risk module, is set out in section E.2. The Group's Own Funds exceeded the SCR by $127,846 thousand at 31 December 2018, resulting in a coverage ratio of 123.9%. The Group met its regulatory capital requirements at all times during the year. Following the determination of the BMA as Group Supervisor from 1 January 2019, it was decided not to renew the LOC of $130,000 thousand used to support LICL's FAL contribution, increasing the Group's level of restricted assets and decreasing the Group's available Own Funds. If the FAL LOC had been retained the coverage ratio would have been approximately 148%. Due to the full consolidation of the Group's Lloyds operations under the BMA model, there was no benefit to Own Funds of renewing the FAL LOC.

From 1 January 2019 the Group is supervised by the BMA and regulatory capital is now assessed under the BMA's SCR formula. The BMA model requires full consolidation of the Group's Lloyd's operations - this reduces the amount of restricted assets within the Group's Own Funds. The coverage ratio as at 1 January 2019 under the Bermuda SCR is 220%.

There were no significant changes to the Group's capital management strategy during 2018.

DIRECTORS' STATEMENT

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

We are satisfied that:

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

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

Alex Maloney
Director/CEO

02 May 2019

Elaine Whelan
Director/CFO

02 May 2019

A1: Business

(A) Name and legal form

The Lancashire Group is a provider of global specialty insurance and reinsurance products with operations in London and Bermuda. LHL was incorporated under the laws of Bermuda on 12 October 2005. On 16 March 2009, LHL was added to the official list and its common shares were admitted to trading on the main market of the LSE; previously LHL's shares were listed on AIM, a subsidiary market of the LSE. Since 21 May 2007, LHL's shares have had a secondary listing on the BSX.

LHL's head office and registered office is Power House, 7 Par-la-Ville Road, Hamilton HM 11, Bermuda.

(B) Supervisory authority and group supervisor

Prior to 1 January 2019 LHL's Group Supervisory Authority was the Prudential Regulatory Authority in the UK, London Markets, Insurance Division, Prudential Regulation Authority, Bank of England, 20 Moorgate, London, EC2R 6DA. From 1st January 2019 LHL's Group Supervisory Authority is the Bermuda Monetary Authority, BMA House 43 Victoria Street, Hamilton, HMJX Bermuda.

(C) External auditor

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

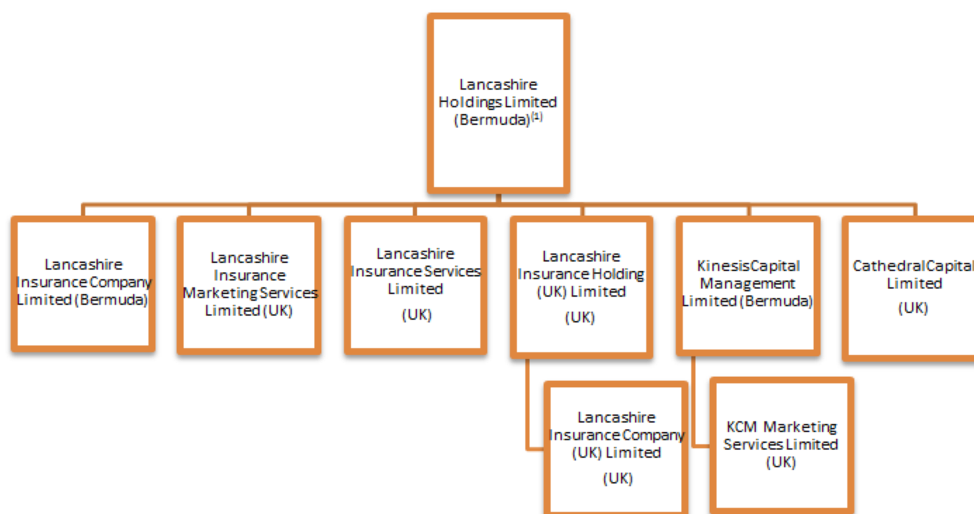
(D) Holders of qualifying holdings

LHL's common shares are traded on the main market of the LSE. Substantial shareholders with more than 5% holding in LHL's issued share capital are disclosed on the Group's website: Share ownership - Lancashire Group. Voting rights are equivalent to share ownership. As at 31 December 2018 qualifying holdings in excess of 10% holding in LHL's share capital comprised the following:

	Location	No of shares held as at 31 December 2018	% of shares in issue
Invesco Limited	UK	32,012,259	15.85

(E) Position within the legal structure of the group

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



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

Further details of all the undertakings in the Group are disclosed in Note 23: Related Party Disclosures of LHL's 31 December 2018 consolidated financial statements included in the 2018 Annual Report and Accounts, available on the Group's website here: Investors – Lancashire Group.

Lancashire Insurance Company Limited ('LICL') and Lancashire Insurance Company (UK) Limited ('LUK') are considered insurance undertakings for the purposes of Solvency II reporting.

Cathedral Capital Limited ('CCL') is the holding company for the Group's Lloyd's platforms, which include:

- Cathedral Underwriting Limited, a Lloyd's managing agency, and
- Cathedral Capital (1998) Limited, a Lloyd's corporate member with 57.8% of the capacity of Syndicate 2010 and 100% of the capacity of Syndicate 3010.

The Cathedral syndicates do not meet the definition of an "insurance undertaking" under the Solvency II Directive as they are not authorised by a European regulator. The Cathedral group of companies are therefore defined as undertakings falling within the Delegated Acts Article 335(1)(f) and are treated as 'related undertakings' in accordance with the Delegated Acts Article 13. As such, for the purposes of Solvency II reporting, the Group values CCL and its subsidiaries using the adjusted equity method (as laid out in the Delegated Acts Article 13), with the valuation based on the Solvency II net asset value of CCL and its subsidiaries and has not fully consolidated the results of CCL into the LHL's consolidated financial statements. For the Group's IFRS reporting CCL and its subsidiaries are fully consolidated. The Cathedral entities report Solvency II information to Lloyd's and form part of Lloyd's Solvency II reporting to the PRA. References to 'the Group' in the performance sections of this report (A2 –A5) therefore exclude details of Cathedral's underwriting, investment and other income.

The Group holds a 10.0% interest in the preference shares of each segregated account of KHL, a company incorporated in Bermuda. KHL's operating subsidiary, KRL, is authorised by the BMA as a Special Purpose Insurer. Key financial information for KHL is disclosed in Note 16: Investment in Associate of LHL's 31 December 2018 consolidated financial statements included in the 2018 Annual Report and Accounts, available on the Group's website here: Investors - Lancashire Group.

The remainder of the Group's subsidiaries are ancillary services companies or insurance holding companies. Voting rights are equivalent to share ownership for the Group's subsidiaries.

(F) Material lines of business

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

(G) Significant events

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

A2: Underwriting performance

(A) Underwriting peformance by line of business

The Group's underwriting performance on an IFRS basis, by Solvency II line of business, is summarised in the tables below and is consistent with the QRT templates S.05.01.01 (see Appendix 1). As the Solvency II prescribed lines of business are different from the Group's defined business segments, and exclude Cathedral's results as described above, the results below are not directly comparable to those disclosed in LHL's 2018 Annual Report and Accounts.

For the year ended 31 December 2018	Marine, aviation and transport insurance $'000	Fire and other damage to property insurance $'000	Credit and suretyship insurance $'000	Non-proportional property reinsurance $'000	Non-proportional marine, aviation and transport reinsurance $'000	Total $'000
Gross premiums written	133,009	65,180	35,474	131,662	16,418	381,743
Outwards reinsurance premiums	(50,355)	(22,537)	(19,427)	(51,091)	(7,511)	(150,921)
Net premiums earned	92,676	38,291	24,023	78,684	13,399	247,073
Gross claims incurred	(49,699)	(1,900)	(13,021)	(77,072)	(3,420)	(145,112)
Claims recoverable	49,985	946	7,148	39,940	480	98,499
Net claims incurred	286	(954)	(5,873)	(37,132)	(2,940)	(46,613)
Net expenses incurred(1)	(49,719)	(14,127)	(5,038)	(14,244)	(2,486)	(85,614)
Underwriting performance	**43,243**	**23,210**	**13,112**	**27,308**	**7,973**	**114,846**

1. Acquisition cost expenses

For the year ended 31 December 2018	Marine, aviation and transport insurance %	Fire and other damage to property insurance %	Credit and suretyship insurance %	Non-proportional property reinsurance %	Non-proportional marine, aviation and transport reinsurance %	Total %
Net loss ratio	(0.3)	2.5	24.4	47.2	21.9	18.9
Net acquisition expense ratio	53.6	36.9	21.0	18.1	18.6	34.7

For the year ended 31 December 2017	Marine, aviation and transport insurance $'000	Fire and other damage to property insurance $'000	Credit and suretyship insurance $'000	Non-proportional property reinsurance $'000	Non-proportional marine, aviation and transport reinsurance $'000	Total $'000
Gross premiums written	161,207	40,600	30,620	126,776	25,111	384,314
Outwards reinsurance premiums	(61,261)	(9,728)	(8,483)	(48,056)	(2,287)	(129,815)
Net premiums earned	118,664	35,738	31,752	78,969	14,043	279,166
Gross claims incurred	(49,445)	(29,671)	(12,879)	(212,422)	(868)	(305,285)
Claims recoverable	24,608	15,213	421	71,680	117	112,039
Net claims incurred	(24,837)	(14,458)	(12,458)	(140,742)	(751)	(193,246)
Net expenses incurred[1]	(49,781)	(7,966)	(5,956)	(13,741)	(2,850)	(80,294)
Underwriting performance	**44,046**	**13,314**	**13,338**	**(75,514)**	**10,442**	**5,626**

1. Acquisition cost expenses

For the year ended 31 December 2017	Marine, aviation and transport insurance %	Fire and other damage to property insurance %	Credit and suretyship insurance %	Non-proportional property reinsurance %	Non-proportional marine, aviation and transport reinsurance %	Total %
Net loss ratio	20.9	40.5	39.2	178.2	5.3	69.2
Net acquisition expense ratio	42.0	22.3	18.8	17.4	20.3	28.8

2018 has once again been an active year with loss quantum being significantly above historical averages, with a high frequency of losses from both natural catastrophe and man-made events. Natural catastrophe losses included the wildfires in California, typhoons in Japan, the Philippines and China and hurricanes in the U.S. 2018 has also seen a sharp increase in man-made losses, with significant loss activity on classes such as downstream energy and marine. Our gross loss ratio was 37.4% (18.9% on a net basis).

Following the record loss events of 2017 we have seen modest improvements in premium rates during 2018. Net premiums earned were $247,073 thousand and we were able to produce an underwriting profit of $114,846 thousand.

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

(I) Marine, aviation and transport insurance and non-proportional marine, aviation and transport reinsurance

This line of Solvency II business includes the majority of our energy, marine and aviation segments as disclosed in our 2018 Annual Report and Accounts.

In the energy market, we saw the first green shoots of recovery in both the energy industry and the upstream energy insurance market. The higher and more stable oil price, combined with our clients now being set up to run more efficiently in a lower oil price environment has meant that demand has stabilised and there are signs that demand may slowly improve as upstream energy clients look to gradually increase their operations. Alongside this, the pricing environment improved slightly with rates rising across the portfolio.

The last few years have been very challenging with rate reductions and a significant reduction in demand causing premiums in the upstream energy market to more than halve. Therefore, these positive signs during 2018 are very welcome. Fortunately, our energy book has remained profitable during this difficult period, albeit helped by the fact there has been less activity and therefore fewer claims; but we welcome the change in outlook and remain aware that an increase in client activity can also lead to an increase in loss activity.

We added a product line under the energy umbrella during 2018, namely downstream energy.

Downstream energy dovetails nicely with our current upstream offering as many of the clients are the same. We have been able to utilise our strong client relationships to access downstream business and prudently build out a portfolio during the year. The downstream market has succumbed to many large losses in 2018, most of which we have been able to avoid, allowing us to make an underwriting profit in the first year of operation, so this has helped push forward rate increases across this market and we expect this to continue into 2019.

During 2018 the hull market saw possibly the largest ever marine builders' risk loss in history. This loss impacted our marine portfolio given that we had a significant share of the risk. A loss of this size inevitably creates an underwriting loss for the class in 2018 albeit, even with this loss and other large losses in the past, our marine portfolio remains profitable since inception, which for marine underwriters is the exception rather than the rule. The marine hull subclass of business has been reviewed by Lloyd's and we have seen a number of markets withdraw from this class, so there is likely to be less capacity available in 2019. There remains global capacity for the product but like any market a reduction in capacity can only help stabilise and possibly improve market conditions for 2019.

Our direct aviation portfolio covers war, hull and AV52 and, more recently, aviation deductible. All these classes have been either in a stable or improving pricing environment during 2018. The decision to enter aviation deductible was a function of this improving market but also, because a large number of our existing aviation clients already buy this cover, it simply adds another aviation product to the range which we offer to our client base, further strengthening our relationships in this class.

Aviation has also seen a number of market participants withdraw during 2018, which we believe will help maintain positive rate movement through 2019 and we are very well placed to benefit from this continued better market.

(II) Fire and other damage to property insurance

This line of Solvency II business largely comprises our terror, political violence and political risk books of business.

The world continued to be a volatile place during 2018 with political issues such as Brexit and U.S. trade wars, as well as violence and civil unrest in areas such as Nigeria, Pakistan, Yemen and Afghanistan.

This global political and socio-economic climate certainly creates challenges for underwriting these classes of business, and risk selection remains absolutely crucial as years of softening rates means that there is little margin to cater for any type of attritional losses.

We are fortunate to have a core portfolio of risks that have historically avoided attrition and therefore continue to deliver healthy underwriting profits. The rating environment has stabilised during the year. This is welcome following continued rate reductions in the terrorism class since we started writing it in 2006. There remains an abundance of capacity in this market given its historic profitability, so our aim will be to maintain our core portfolio in 2019 and grow in any areas that match our risk appetite. Over the past few years we have successfully grown in areas such as UK terrorism which goes some way towards replacing income lost to broker facilities, which has been a trend in this market for the past few years. We remain highly selective when we agree to give up our underwriting pen as we continue to believe that underwriters selecting risks generates a superior underwriting return.

(III) Credit and suretyship insurance

This line of Solvency II business largely comprises our sovereign obligors book of business.

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

(IV) Non-proportional property reinsurance

This line of Solvency II business largely comprises our property catastrophe and property retrocession books of business.

2018 has once again been a very challenging year for this class of business. The loss events in Japan, the Philippines and the U.S. have not been as significant in terms of insured loss as 2017. However, they have been as frequent and of a level significant enough to impact underwriting profitability. Rating across the portfolio improved year on year, albeit with rate increases reducing as the renewal season progressed. Supply of capacity did not shrink and therefore the rate increases were dampened as market participants protected market share.

Looking ahead, the loss events of this year will most likely mean that property reinsurance pricing should remain at least stable through 2019. If there is dislocation in the market for retrocession capacity then this could impact the demand and supply dynamic and push rates further forward. The relatively immature ILS market faces a second year of losses that will trap and erode capital and produce another test of the product and the capital.

The Group, is uniquely placed to maximise any opportunity that manifests itself with the ability to offer clients and brokers a choice of platforms and products and additional capacity should the risk and return metrics allow.

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

(B) Underwriting peformance by geographical area

The Group's underwriting performance by geographical area is detailed in Appendix 1: S.05.02.01 – premiums/claims/expenses by country QRT. All business is underwritten in Bermuda, by LICL, and the UK, by LUK, and risks covered are worldwide. Cathedral's business is underwritten in the UK; this is not included in template S.05.01.02 due to the accounting of Cathedral under the adjusted equity method for Solvency II purposes. LICL, as the holder of the majority of the Group's capital, facilitates the acceptance of larger risks, both on its own account and as a reinsurer of the direct writers in the group at LUK and Cathedral. It writes the larger reinsurance and retrocession risks often of worldwide or super-regional cedents. LUK writes mostly direct insurance with a leading presence in the energy, terrorism, political risk, marine hull and AV52 markets.

The S.05.01.02 QRT in Appendix 1 discloses underwriting performance by geographical area according to the specific Solvency II requirements for this form and the resulting geographical area splits do not necessarily reflect the location of risk or the location of underwriting. The Solvency II defined geographical area for the fire and other damage to property and credit and surety lines of business is the location of risk, for the marine, aviation and transport line of business it is the location where the contract was entered into and for non-proportional business it is the location of the client.

A3: Investment performance

(A) Investment income and expenses

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

For the year ended 31 December 2018	Interest income $'000	Net gains and losses $'000	Unrealised gains and losses $'000	Total $'000
Government bonds	2,676	1,224	745	4,645
Corporate bonds	16,070	(3,497)	(7,419)	5,154
Structured notes	690	—	(684)	6
Collateralised securities	3,747	(889)	(4,766)	(1,908)
Collective investments undertakings	1,882	(357)	(1,834)	(309)
Derivatives	—	2,583	(1,069)	1,514
Loans and mortgages	4,808	34	(5,703)	(861)
Total	**29,873**	**(902)**	**(20,730)**	**8,241**

For the year ended 31 December 2017	Interest income $'000	Net gains and losses $'000	Unrealised gains and losses $'000	Total $'000
Government bonds	3,649	(1,209)	673	3,113
Corporate bonds	12,814	(444)	2,270	14,640
Structured notes	715	2,388	(948)	2,155
Collateralised securities	3,865	157	5,360	9,382
Collective investments undertakings	(383)	10,588	5,344	15,549
Derivatives	—	(4,020)	2,649	(1,371)
Loans and mortgages	5,319	(552)	(623)	4,144
Total	**25,979**	**6,908**	**14,725**	**47,612**

Since inception, the primary objectives for our investment portfolio have been capital preservation and liquidity. Those objectives remain unchanged, and are more important than ever in today's volatile and reactive markets. As market volatility continues, we position our portfolio to limit downside risk in the event of market shocks. In 2018, our focus has been on managing our interest rate risk, the largest risk to our predominantly fixed maturity portfolio. We continue to maintain a short-duration fixed maturity portfolio and have been using our risk budget to add products to our portfolio to help mitigate a rise in rates.

Our portfolio mix illustrates our conservative philosophy. With the composition regulated by the Group's investment guidelines, we have three investment portfolio categories: 'core', 'core plus' and 'surplus'. The core and core plus portfolios contain at least enough funds required to meet near-term obligations and cash flow needs following an extreme event. Assets in excess of those required to be held in the core and core plus portfolios may be held in any of the three portfolio categories.

We produced a total investment return of $8,241 thousand in 2018 (2017 - $47,612 thousand). The investment return was driven by positive returns on the Group's standard fixed maturity portfolios as coupon returns more than offset the increase in treasury yields and widening of credit spreads that took place in 2018. Returns on the fixed maturity mandates outweighed the small losses on the equities, hedge funds and bank loans during the year.

No investment income is received from the Group's holdings in related undertakings. Cathedral's investment return is excluded from the analysis above as it is not consolidated on a line-by-line basis under Solvency II.

(B) Investment gains and losses recognised directly in equity

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

(C) Investments in securitisation

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

As at 31 December	2018 Total $'000	2017 Total $'000
Asset backed securities	113,476	128,241
Non-agency commercial mortgage backed securities	—	232
Non-agency mortgage backed securities	14,397	9,954
U.S. government agency mortgage backed securities	21,482	30,128
Total collateralised securities	**149,355**	**168,555**

In both 2018 and 2017 all the collateralised investments are determined as Level (ii) investments in the fair value hierarchy as described on page 143 and 144 of LHL's 31 December 2018 consolidated financial statements included in LHL's 2018 Annual Report and Accounts, available on the Group's website here: Investors - Lancashire Group.

The total return from these investments for the year ended 31 December 2018 was a loss of $1,908 thousand (2017 - profit of $9,382 thousand).

A4: Performance of other activities

(A) Other income

The Group's other income comprises contributions from third party capital activities as follows:

For the year ended 31 December	2018 Total $'000	2017 Total $'000
Kinesis underwriting fees	6,617	5,808
Kinesis profit commission	—	5,869
Share of loss of associate	(7,132)	(9,422)
Total contribution from third party managed capital	**(515)**	**2,255**

In 2013, KCML entered into an underwriting services agreement with KRL and KHL to provide various services relating to underwriting, actuarial, premium payments and relevant deductions, acquisition expenses and receipt of claims. For the year ended 31 December 2018, the Group recognised $6,617 thousand (2017 - $11,677 thousand) of service fees and profit commissions in other income in relation to this agreement.

The Group holds a 10.0% interest in the preference shares of each segregated account of KHL, a company incorporated in Bermuda. KHL's operating subsidiary, KRL, is authorised by the BMA as a Special Purpose Insurer. KRL commenced writing insurance business on 1 January 2014. As at 31 December 2018, the carrying value of the Group's investment in KHL was $67,079 thousand (31 December 2017 - $59,446 thousand). The share of loss of associate reflects Lancashire's 10% interest in the Kinesis vehicle.

Lloyd's fees and profit commissions reflecting Cathedral's charges to third party Lloyd's Names in respect of the management of Syndicate 2010, together with profit commissions on consortium business have not been included in the table above due to the non-consolidation of Cathedral on a line-by-line basis for Solvency II.

(B) Other operating expenses

Other operating expenses are summarised in the table below:

For the year ended 31 December	2018 Total $'000	2017 Total $'000
Employee remuneration costs	41,894	35,814
Other operating expenses	29,718	32,186
Total	**71,612**	**68,000**

Employee remuneration costs for the year ended 31 December 2018 were higher than the same period in 2017. The increase was primarily due to increased headcount following the recruitment of new underwriters and underwriting teams and an increase in the variable compensation element of employee remuneration costs compared to 2017, given the relative performance of the Group.

(C) Equity based compensation expenses

Equity based compensation expenses were $7,305 thousand for the year ended 31 December 2018 (2017 - $2,109 thousand). The equity based compensation charge is driven by the anticipated vesting level of the active awards based on current performance expectations.

(D) Financing costs

Financing costs are summarised in the table below:

For the year ended 31 December	2018 Total $'000	2017 Total $'000
Interest expense on long term debt	14,142	13,142
Net (gains) on interest rate swaps	(899)	(36)
Other financing costs	2,912	1,128
Total	**16,155**	**14,234**

Disclosure of the details of the Group's long term debt and financing arrangements are available in Note 18: Long-term Debt and Financing Arrangements of LHL's 31 December 2018 consolidated financial statements included in LHL's 2018 Annual Report and Accounts, available on the Group's website here: Investors - Lancashire Group. Note that the financing costs related to the Group's loan notes assumed as part of the Cathedral acquisition in 2013, issued by CCHL and disclosed in LHL's Annual Report and Accounts, are not included in the table above as the Cathedral companies are not consolidated into the Solvency II Group on a line-by-line basis, as previously noted in this report.

(E) Leasing arrangements

The Group's operating lease arrangements are disclosed in Section D.3.A below.

A5: Any other information

All material information regarding the Solvency II Group's business and performance by Solvency II lines of business is disclosed in sections A2 – A4 above. Further analysis on the Group's performance on an IFRS basis, including the performance of the Cathedral Lloyd's entities, can be found in the 'performance' section of LHL's 2018 Annual Report and Accounts available on the Group's website here: Investors - Lancashire Group.

Transactions within the Group: Associate

During 2018, the Group committed an additional $35,783 thousand (31 December 2017 - $57,507 thousand) of capital to KHL. During 2018, KHL returned $21,017 thousand (31 December 2017 - $38,443 thousand) of capital to the Group. Other transactions with KRL and KHL during the year are disclosed in Section A.4 (A) above and in Note 23: Related Party Disclosures to the LHL's 31 December 2018 consolidated financial statements, available on the Group's website here: Investors - Lancashire Group.

Transactions within the Group: EBT

The EBT was established to assist in the administration of the Group's employee equity based compensation schemes. The Group has a Loan facility Agreement (the "Facility") with RBC Cees Trustee Limited, the trustee of the EBT. The Facility is an interest free revolving credit facility under which the trustee can request advances on demand, within the terms of the Facility, up to a maximum aggregate of $80,000 thousand. The Facility may only be used by the trustee for the purpose of achieving the objectives of the EBT. During the year ended 31 December 2018, the Group had made advances of $1,500 thousand (2017 - $6,000 thousand) to the EBT under the terms of the Facility.

During the year ended 31 December 2018, the Group donated nil treasury shares (2017- 1,415,058) to the EBT at the prevailing market rate. The trust purchased 600,000 treasury shares at the prevailing market rate (2017 - nil). The total value of the treasury shares donated by the Company was $nil (2017 - $12,826 thousand) and purchased by the trust was $4,571 thousand (2017 - $nil).

Transactions within the Group: Intra-Group Reinsurance

LICL and LUK have entered into a QST agreement. Under this agreement LUK cedes a share of all its business written or assumed. During the year ended 31 December the following amounts were ceded from LUK to LICL under the terms of this agreement:

For the year ended 31 December	2018 Total $'000	2017 Total $'000
Gross premiums written	**98,232**	123,299
Change in unearned premiums	**22,106**	18,076
Insurance losses and loss adjustment expenses	**13,477**	43,198
Insurance acquisition expenses	**61,301**	56,550

LICL holds $191,944 thousand (31 December 2017 - $245,302 thousand) of cash and cash equivalents, fixed maturity securities and accrued interest in trust for the benefit of LUK relating to the intra-group reinsurance agreements.

LICL and CCL 1998 have also entered into a QST agreement. Under this agreement CCL 1998 cedes 85.0 % of its financial result to LICL, totalling $13,937 thousand loss for 2018 (2017 - $49,189 thousand loss). Under the terms of this agreement LICL is required to provide 85.0 % of the required FAL to support the underwriting activities of CCL 1998 as a member of Syndicates 2010 and Syndicate 3010. As at 31 December 2018 LICL holds $267,894 thousand (31 December 2017 - $109,246 thousand) of cash and cash equivalents and fixed maturity securities in FAL in relation to intra-group reinsurance agreements. The $130,000 thousand syndicated uncollateralised facility put in place during 2017 for FAL purposes was not renewed at expiry.

Transactions within the Group

During the year ended 31 December 2018, the Board of Directors of LICL authorised dividend distributions totalling $125,000 thousand (31 December 2017 - $35,000 thousand) to LHL.

B.1 General information on the system of governance

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

Good strategic debate and decision making remain central to the work of any board. At Lancashire we are fortunate in having a nimble strategy and a simple 'flat' structure with a total employee headcount at 31 December 2018 of 218. This means that all our Directors have regular opportunities to meet with both the members of our management team and other employees within the business. That helps inform our Board's active understanding of the business, its needs and challenges.

Further to the requirements of Solvency II, UK regulated insurers are required to prepare an ORSA report. Both the management team and the Board have engaged fully with the ORSA process, and use it as a tool to help deepen our understanding of our business, better understand the risks and opportunities facing it and to refine and focus Lancashire's strategic thinking and priorities. With the change in Group Supervision effective 1 January 2019 the ORSA report being prepared for review, challenge and approval by the LHL Board at the 2019 first quarter meeting is a transitional ORSA moving from the PRA's supervisory regime to the BMA's supervisory regime.

As a premium-listed company on the LSE, Lancashire measures its corporate governance compliance against the requirements of the UK Corporate Governance Code published by the UK FRC. The Company has a robust Board and Committee structure. The Board has established Audit, Investment, Nomination and Corporate Governance, Underwriting and Underwriting Risk and Remuneration Committees. Certain matters are reserved for the Board such as strategy, internal controls and risk. Details of Board Committees and key functions are provided below. There have been no changes to the Company's governance structure during the year. The Group also monitors its compliance with applicable corporate governance requirements under Bermuda law and regulations.

Please refer to the Corporate Governance section starting at page 48 of LHL's Annual Report and Accounts for 31 December 2018 for additional details on the Group's system of governance, supplementary to that disclosed below: Investors - Lancashire Group.

(A) Group board and committees

The Board of Directors is responsible for the leadership and control and the long-term success of Lancashire's business. The Board has reserved a number of matters for its decision, including responsibility for setting the Group's values and standards, and approval of the Group's strategic aims and objectives. The Board is responsible for setting the Group's risk appetites, defining its risk tolerances, and setting and monitoring the Company's risk management and internal control systems including compliance with risk tolerances. During 2018 the Board carried out a robust assessment of the principal risks affecting the Group's business model, future performance, solvency and liquidity and the operation of internal control systems.

The Board has delegated certain matters to Committees of the Board. There are a number of matters which the Board considers not suitable for delegation including: approval of dividends and dividend policy; receiving reports from the Group CRO and legal and compliance department; approval of the Annual Report and Accounts and any qualification thereon; approval of significant changes in accounting policy or practice; approval of annual Solvency II regulatory submissions; appointments and removal of directors and the Company Secretary; selection of the Chairman and CEO; committee membership and chairmanship; appointment and removal of external auditors; division of responsibilities between the Group Chairman and CEO; approval of committee Terms of Reference; receiving committee reports; and determining the independence of directors. Further details pertaining to the Board's schedule of reserved matters are available on the Group's website here: Our Board - Lancashire Group.

Further information relating to the Group Board committees can be found on pages 55 to 69 of LHL's 2018 Annual Report and Accounts, available on the Group's website here: Investors - Lancashire Group.

The Board carries out its duties in accordance with LHL's bye-laws, resolutions of the company and general law. The Board has established Audit, Investment, Nomination and Corporate Governance, Underwriting and Underwriting Risk and Remuneration Committees. Each of the Committees has written Terms of Reference, which are reviewed regularly and are available on the Company's website. The Committees' Terms of Reference were reviewed by the Board during 2018 and were considered to be in line with current best practice. The Committees are generally scheduled to meet quarterly, although additional meetings and information updates are arranged as business requirements dictate. Directors attendance of the 2018 Board and Committee meetings is set out in the tables on pages 58 to 68 of LHL's Annual Report and Accounts for 31 December 2018.

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

The Board also meets to discuss strategic planning matters outside the formal meeting schedule. A Board strategic planning session was held in May 2018. Full disclosure of the Board and Committee's activities during the year are disclosed on pages 52 to 54 of LHL's Annual Report and Accounts for 31 December 2018 Investors - Lancashire Group.

The Board has approved and adopted a formal division of responsibilities between the Chairman and the CEO. The Chairman is responsible for the leadership and management of the Board and for providing appropriate support and advice to the CEO. The CEO is responsible for the management of the Group's business and for the development of the Group's strategy and commercial objectives. The CEO is responsible, along with the executive team, for implementing the Board's decisions.

(B) Roles and responsibilities of key functions

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

(I) Risk management function

The risk management function at Lancashire oversees all the Group and entity level risk management duties. The function is led by Louise Wells, CRO, who is a Fellow of the Institute of Chartered Accountants of England and Wales and fulfils the UK regulators' controlled function role of CRO (SMF4). The Group CRO reports to the LHL, LUK, and LICL boards; the Cathedral CRO reports to the CUL board and risk, capital and compliance committee. The Group CRO is supported by the Cathedral CRO and a number of additional individuals who are deemed to be sufficiently skilled to perform risk management function duties. The risk management function therefore has the required skills, knowledge and expertise to fulfil its duties.

Whilst risk is considered at Board level, committees of the Board have responsibility for various aspects of risk. The Group CRO reports directly to the Group and subsidiary boards and facilitates and aids the identification, evaluation, quantification, mitigation and control of risks at a Group and subsidiary level. The Group CRO provides regular reports to the Group and subsidiary boards covering, amongst other things, actual risk levels against tolerances, emerging risks and any lessons learned. The Board considers that a supportive ERM culture, established at the Board and embedded throughout the business, is of key importance. Facilitating and embedding ERM, and helping the Group to improve its ERM practices, is a major responsibility assigned to the Group CRO.

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

(II) Internal audit function

The internal audit function at Lancashire oversees all the Group and entity level internal audits. The function is led by Samantha Churchill, Head of Internal Audit, who is a Fellow of the Institute of Chartered Accountants of England and Wales and will fulfil the UK regulators' controlled function role of Head of Internal Audit (SMF5) when approved by the PRA. The Head of Internal Audit reports to the LHL, LUK and CUL Audit Committees and the LICL board and is supported by a number of additional individuals who are deemed to be sufficiently skilled to perform internal audit function duties. The internal audit function has the required skills, knowledge and expertise to fulfil its duties. Internal audit plays a key role in the Group's ERM by providing an independent opinion regarding the accuracy and completeness of risks in the risk register, in addition to verification of the effectiveness of controls and the consistency of their operation.

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

The internal audit function is described more fully in Section B.6 below.

(III) Compliance function

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

We maintain separate compliance functions across our operating entities to ensure that we maintain our focus on the specific legal and regulatory issues in each of our operating jurisdictions. Within the UK, the function is led by Michael Connor, LUK General Counsel & Company Secretary, who is a qualified solicitor and fulfils the UK regulators' controlled function role of Compliance Oversight Officer (SMF16), Money Laundering Reporting Officer (SMF17) and Director of LUK (SMF3). The LUK General Counsel reports to the Group General Counsel. The compliance function at both the Group and legal entity level is supported by a number of additional individuals who are deemed to be sufficiently skilled to perform compliance function duties. The compliance function has the required skills, knowledge and expertise to fulfil its duties. The compliance function is deemed sufficiently independent and has performed its duties in an objective and fair manner. The function has direct access to the Lancashire Board, via the Group General Counsel, and to the regulated Boards via other team members, to report on any matters that may impact its ability to perform its duties effectively.

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

(IV) Actuarial function

The actuarial function at Lancashire oversees all the Group and entity level actuarial duties. The Group Chief Actuary, Ben Readdy, holds the position as Actuarial Function lead. Ben is a Fellow of the Institute and Faculty of Actuaries (IFoA). Ben fulfils the UK regulators' controlled function role of Chief Actuary (SMF20). Further, as required by the IFoA, Ben also holds a UK Practising Certificate and complies with the additional requirements from the IFoA to maintain this certificate. The Chief Actuary is supported by a number of additional individuals who are deemed to be sufficiently skilled to perform actuarial function duties. The actuarial function has the required skills, knowledge and expertise to fulfil its duties.

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

(V) Internally defined key functions

The following functional areas have been deemed as important within the Group's system of governance by the Group's management. To comply with the UK regulators' SM&CR regime each of these areas within LUK has a SMF owner, as disclosed in LUK's SFCR (pages 14 to 15) saved on the Group's website here: https://www.lancashiregroup.com/content/dam/lancashire/corporate/documents/Our Businesses/Lancashire/18 12 31 LUK SFCR.pdf.

The leaders of these functions at the Group level and each function's key responsibilities are disclosed below. Each of these functional areas is supported by appropriate resources, both in quantum and in terms of experience and skills, at the Group and individual entity level, to enable them to perform their duties with the required skill, knowledge and expertise.

Finance and investment management

The Group finance and investment function at Lancashire oversees all the Group and entity level finance and investment management matters. The function is led by Elaine Whelan, Group CFO, and LICL CEO, who is an Executive Director of the LHL, LICL and KCM Boards. Its key responsibilities are: the provision of internal and external financial reporting that complies with the relevant IFRS and regulatory guidelines on a timely basis; capital management; business planning and forecasting; and to ensure that the Group's external investment portfolio is managed in accordance with the Group's investment strategy and investment guidelines and risk parameters.

Underwriting and reinsurance

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

Claims management

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

IT

The Group IT function at Lancashire oversees all the Group and entity level IT matters. The function is led by Paul Gregory, who reports to the Group CEO, Alex Maloney. Paul Gregory is the Group CUO, LUK CEO and an Executive Director of the LUK Board and is assisted by the Group Chief Information Officer, Richard Hayes. Its key responsibilities are to deliver IT services and support in alignment with the Group's corporate strategy.

(C) Any material changes in the system of governance that have taken place over the reporting period

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

(D) Remuneration policy and practices

Detailed information concerning the Group's remuneration policies and practices can be found on pages 70 to 89 of LHL's Annual Report and Accounts for 31 December 2018: Investors - Lancashire Group

(I) Remuneration policy principles

The Group's goal continues to be to reward its employees fairly and responsibly by providing an appropriate balance between fixed remuneration and variable remuneration, linked to the achievement of suitably challenging Group and individual performance measures.

There is a strong link between the Remuneration Policy and the business strategy. The Group's strategy focuses on the effective operation of the business necessary to maximise long-term RoE and the delivery of superior total shareholder returns on a risk-adjusted basis over the course of the insurance cycle. Our Remuneration Policy and the way it is implemented are closely aligned to this strategy. The Remuneration Committee of the Board of Directors sets the Remuneration Policy for the Group's Chairman, the Executive Directors, Company Secretary and other designated senior executives to deliver long-term benefits to the Group. The full terms of reference for the Remuneration Committee are available on the Group's website here: Board Committees - Lancashire Group

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

The Remuneration Policy for all staff is, in principle, broadly the same as that for Executive Directors in that any of the Group's employees may be offered similarly structured packages, with participation in annual bonus and long-term incentive plans, although award types (restricted cash, restricted stock or performance shares) and size may vary between different categories of staff. For Executive Directors, with higher remuneration levels, a higher proportion of the compensation package is subject to performance pay, share based remuneration and deferral. This ensures that there is a strong link between remuneration, Group performance and the interests of shareholders.

The Group has a Solvency II remuneration policy which seeks to identify key staff at both Group and subsidiary level so as to ensure appropriate oversight of the remuneration of such individuals. During 2018 this policy was reviewed and updated where required.

The NED's are paid a single fee for all responsibilities, although supplemental fees may be payable where additional responsibilities are undertaken, including a NED role on a subsidiary board.

(II) Performance criteria

Bonus Plan

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

The financial component is based on the Group's key financial measures of performance. For any year, these may include RoE, growth in BVS, profit, comprehensive income, combined ratio, investment return or any other financial KPI.

Typically, a sliding scale of targets applies for financial performance targets. Bonus is earned on an incremental basis once a predetermined threshold level is achieved. The degree of stretch in targets may vary each year depending on the business aims and the broader economic or industry environment at the start of the relevant year.

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

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

Further details of the performance criteria for the 2018 annual bonus award for the Group's CEO and CFO are disclosed on pages 81 and 82 of LHL's Annual Report and Accounts for 31 December 2018: Investors - Lancashire Group.

Long Term Incentives

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

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

(III) Pension or early retirement schemes

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

(E) Material transactions with shareholders, persons who exercise a significant influence, and with members of the administrative, management or supervisory body

Dividends

For the year ended 31 December 2018, the following dividends were declared:

- An interim dividend of $0.05 per common share was declared on 17 August 2018 and paid on 12 September 2018.
- A special dividend of $0.20 per common share was declared on 9 November 2018 and paid on 12 December 2018.
- A final dividend of $0.10 per common share was declared on 13 February 2019 and paid on 27 March 2019.

Share Repurchases

At the AGM held on 2 May 2018, the Group's shareholders approved a renewal of the Repurchase Programme authorising the repurchase of a maximum of 20,134,191 shares, with such authority to expire on the conclusion of the 2019 AGM or, if earlier, 15 months from the date the resolution approving the Repurchase Programme was passed. There were no share repurchases during 2018.

During the year ended 31 December 2018, no shares were donated to the EBT. The trust purchased 600,000 shares at a market value of $4,571 thousand and distributed 800,776 shares with a market value of US$7,300 thousand, in accordance with the terms of the trust.

Transactions with Members of the AMSB

Remuneration for members of the AMSB is disclosed in the Directors' Remuneration Report section of LHL's Annual Report and Accounts for 31 December 2018, and in Note 23: Related Party Disclosures to LHL's 31 December 2018 consolidated financial statements, available on the Group's website here: Investors - Lancashire Group.

The senior management team shareholding in KCML represents a minority interest of 6.5%. This investment represents the non-controlling interest listed in the Group's consolidated balance sheet. During the year ended 31 December 2018 dividends of $nil were paid to minority interest holders. As at 31 December 2018 Mr Alex Maloney, a director of LHL, had a 1.2% interest in KCML. During the year ended 31 December 2018 Mr Maloney received a dividend of $nil in relation to his interest in KCML.

Mr Maloney and his spouse, acquired 100% of the shares in Nameco on 7 November 2016. Nameco provides capacity to a number of Lloyd's syndicates including Syndicate 2010 which is managed by CUL. Nameco has provided $195 thousand of capacity to Syndicate 2010 for the 2018 year of account. Mr Maloney receives a proportionate share of the underwriting results of Syndicate 2010 to which he is contractually entitled through his participation.

B.2 Fit and proper requirements

(A) Skills, knowledge and expertise applicable to the persons who effectively run the undertaking or have other key functions

The Group has implemented a 'fit and proper' policy and process for persons who effectively run the Group or hold other key functions. The fit and proper policy explicitly covers the Chairman, CEO, Chairman of the Audit Committee, Chairman of the Remuneration Committee, Company Secretary, CFO, Group CRO, Compliance Oversight Officer and the Heads of Internal Audit and Actuarial functions. The Group defines key functions as those prescribed by the relevant regulators as well as those functions which the Group considers to be important within the system of governance. Following the implementation of the SIMR in 2016 and then the SM&CR from 2018 certain controlled functions were designated SMF functions, requiring a regulatory pre-approval process to be followed prior to appointment. This requires the firm to provide the PRA with relevant information regarding an individual's skills and experience, roles and responsibilities and fitness and propriety. Each of the areas considered a 'key function' within LUK has a SMF owner, as disclosed in LUK's SFCR (pages 14 to 15) saved on the Group's website here: https://www.lancashiregroup.com/content/dam/lancashire/corporate/documents/OurBusinesses/Lancashire/181231LUKSFCR.pdf.

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

The Group has the following principal requirements for key function holders:

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

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

- There is a professional management team which ensures that the Group is run in accordance with all relevant legal and regulatory requirements;
- There is an understanding of the insurance products and processes and the market in which it operates;
- There is an understanding of the finance and actuarial functions including the financing, investments and financial markets, actuarial principles and reinsurance;

- There is an understanding of administrative structures and processes within the organisation including internal controls, information technology and risk management;
- There is an understanding of financial accounting and reporting;
- There is an understanding of any outsourcing arrangements and their proper control; and
- Overall, the collective knowledge should be of an adequate level and consist substantially of individuals each with several years of experience in management of an insurer.

(B) Fitness and propriety of the persons who effectively run the undertaking or have other key functions

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

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

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

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

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

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

B.3 Risk management system including the own risk and solvency assessment

(A) Risk management system

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

(I) Strategies, processes and reporting procedures

Risk Strategy:

The primary objective of the Group's ERM framework is to ensure that the capital resources held are matched to the risk profile of the Group and that the balance between risk and reward is considered as part of all key business decisions.

Our overall strategic goal remains to maximise risk-adjusted return for our shareholders across the cycle. We also aim to be profitable 4 years out of 5 targeting a maximum modelled exposure of 25% of our capital to a peak zone loss, be this to a 1 in 100 wind event or a 1 in 250 quake event. In order to achieve these objectives, we employ an effective risk management framework. All of Lancashire's strategic ERM objectives have a common aim of supporting Lancashire's business and capital strategy. Within this context, the primary strategic ERM objectives are to:

- Ensure that all key decisions and risk taking will be undertaken within boundaries that are defined clearly and aligned to the strategic objectives and risk profile of the Group; and
- Promote informed risk taking that considers the risk reward equation in all major decisions with a view to optimising risk adjusted RoE.
- Other key objectives are to:
- Encourage a culture of risk challenge, questioning and understanding including the use of stress, reverse stress and scenario testing to verify assumptions and loss scenarios;
- Quantify and assign risk values to the key risks (within each risk category) to which it is exposed and maintain a risk register to track and manage such risks; and
- Ensure that the Group's capital resources are aligned with risk levels and comply with our regulatory obligations in the UK and Bermuda with regard to the requirements of the Solvency II Directive and BMA capital requirements respectively.

Risk Appetite

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

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

Risk Universe

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

The risk universe categorises risks into three broad classes: intrinsic risk, operational risk and other risk. These risks for the Group are described in more detail on pages 35 to 37 of LHL's Annual Report and Accounts for 31 December 2018, available on the Group's website here: Investors - Lancashire Group.

The categorisation in the risk universe is supported by a more granular risk taxonomy demonstrating the linkage between the risk universe, the capital models, the detailed LHL, LICL and LUK Risk Registers and key monitoring and reporting processes. The risk universe and taxonomy are key to enabling the risk profile across different entities to be aggregated and reported coherently both internally and externally.

Risk Policy Framework

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

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

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

ERM Processes and Reporting Procedures:

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

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

Annual Processes

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

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

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

Regulatory Capital Submissions – The process is initiated by the regulatory reporting and finance teams in line with regulatory requirements that apply to the Group and individual subsidiaries.

Standard Formula Assessment – An SF SCR is calculated annually for the Group (and more frequently in the event of a material change in the business's risk profile) in accordance with regulatory reporting requirements. In concurrence with this, an assessment of the appropriateness of the standard formula for the Group's risk profile is conducted. This assessment considers the significance with which the Group's risk profile deviates from the assumptions underlying the Standard Formula calculation. The reporting of the results includes sufficient detail to demonstrate to the Board the key processes applied and any material assumptions and or limitations of the approach. From 2019 onwards a BMA SCR will be calculated annually for the Group.

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

The report comprises the following sections:

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

Annual ORSA Process and Report – On an annual basis the Group CRO performs an assessment of the Group's overall solvency needs and produces a report detailing Lancashire's risk profile and the capital and other means needed to address these risks (the ORSA report). In addition the ORSA provides a forward looking analysis of risk and the associated capital requirement. Stress and scenario tests are performed on both the SCR and business plan and the results included within the ORSA. The ORSA is reviewed, challenged and approved by the LHL Board of Director's at the first quarter board meetings. With the change in Group Supervision effective 1 January 2019 the ORSA report being prepared for review, challenge and approval by the LHL Board at the 2019 first quarter meeting is a transitional ORSA moving from the PRA's supervisory regime to the BMA's supervisory regime.

Quarterly Processes

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

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

The quarterly ORSA report is reviewed and challenged, as appropriate by the Board; formal approval is only requested when decision items are included in the paper, for example annual review and approval of risk appetite statements.

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

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

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

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

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

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

Management Committee Reviews

RRC Review – The RRC includes the Group CEO and members from the finance team, capital management, actuarial, underwriting and operations functions and includes representation from Cathedral. The Group CRO attends the meetings and reports on the RRC's activities to the Group and individual entity Boards of Directors. The CUL CRO is the link to the Risk, Capital and Compliance Committee of Cathedral. The RRC meets on approximately a bi-weekly basis covering a range of ORSA related topics set out in their terms of reference and annual timetable, both of which are reviewed on an annual basis to ensure that they best meet the Group's needs in a changing internal and external environment.

The RRC considers the core insurance risk profile against Group and subsidiary risk tolerances on a monthly basis for elemental PML modelling and quarterly for non-elemental RDS analysis. The RRC has a key role in terms of oversight of the BLAST capital model for Lancashire, evaluating the appropriateness of and any proposed major changes to its design, implementation and operation and ensuring that it remains an effective tool to support decision making.

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

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

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

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

On-going Management Processes

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

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

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

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

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

Regulatory Capital Monitoring – The Group is subject to regulatory requirements in respect of Solvency II supervision of LHL and regulation of LUK, BMA regulation of LICL and Lloyd's supervision of CUL and its subsidiaries. In addition, the Group maintains and operates a series of processes to ensure and evidence continued compliance with their regulatory requirements and resultant changes in regulatory and supervisory arrangements.

Operational Risk Management – The Group maintains risk registers encompassing assessments of all material operational risks and the controls designed to prevent, mitigate or detect them at both Group and entity levels.

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

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

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

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

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

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

(II)ORGANISATIONAL STRUCTURE AND DECISION-MAKING PROCESSES

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

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

The RRC, under the chairmanship of the Group CEO, is the key management tool for monitoring and challenging the assessment of risk on a continual basis. The RRC agenda is reviewed each year to ensure its activities remain appropriate and aligned with the business cycle.

Chief Risk Officer

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

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

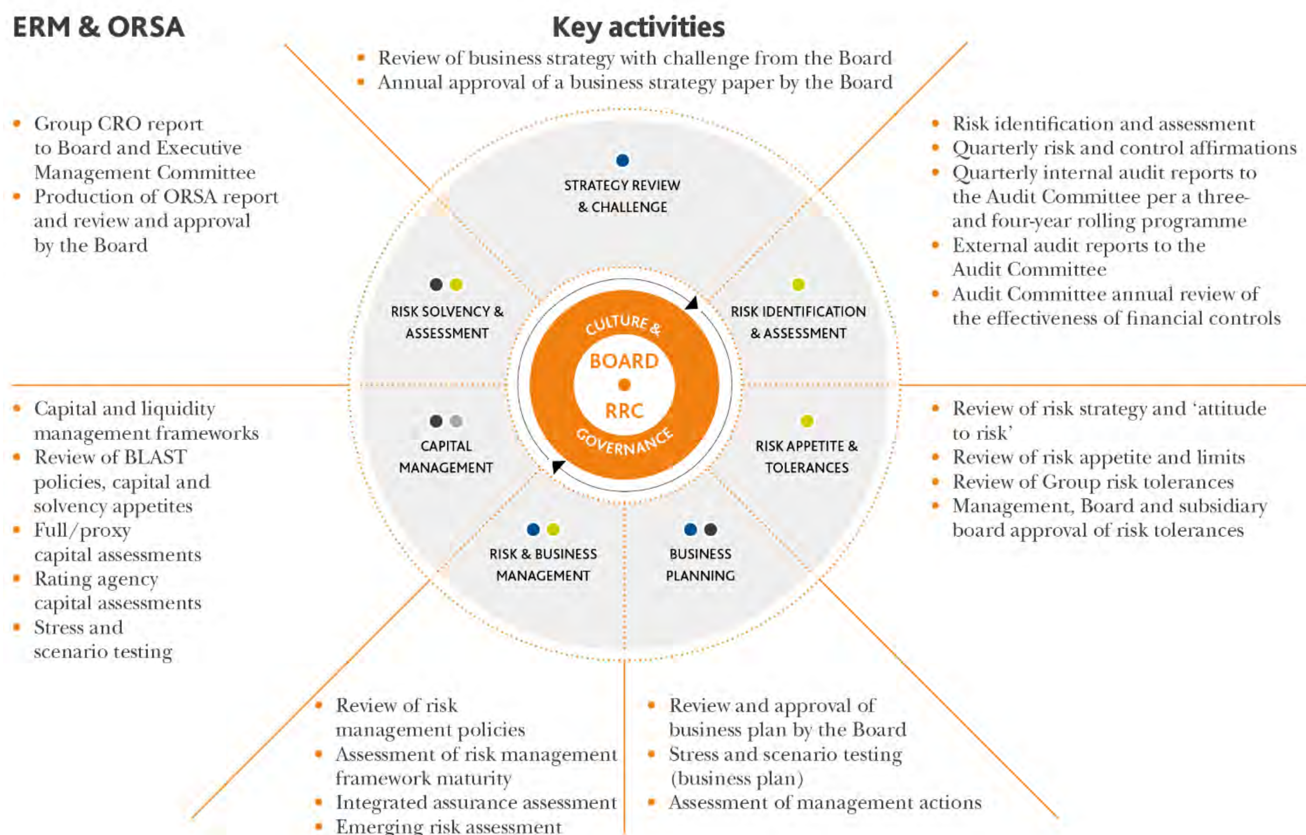
Responsibility for the management of individual risks has been assigned to, and may form part of the performance objectives of, the risk owners within the business. Risk owners ensure that these risks and controls are consistent with their day-to-day processes and the entries made in the Group risk registers,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

(B) ORSA

(I) ORSA process

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

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



ORSA Supervisory Report

The ORSA report is a material output of the ongoing ORSA and ERM processes. It reports on the dynamic elements of the ORSA process, focusing on the moving components of the Group's solvency and risk profile to enable management to make informed decisions. The PRA confirmed that a single ORSA, covering both the Group and LUK should be submitted rather than one each, for the annual periods 2016 to 2018. With the change in Group Supervision effective 1 January 2019 the Group ORSA report being prepared for review, challenge and approval by the LHL Board at the 2019 first quarter meeting is a transitional ORSA. A solo entity ORSA will be prepared for LUK and submitted to the PRA in line with regulatory requirements.

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

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

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

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

(II) ORSA: board review and approval

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

(III) Solvency needs and risk profile

As part of the Group's ongoing ORSA process, the Group excluding Cathedral, models the internal view of its risk profile within its internal economic capital model, BLAST. The BLAST model reflects the aggregate risk profile and models all of Lancashire's major risk categories. It combines the LICL, LUK and KCM risk profiles.

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

Risk tolerances are set at a level that aims to prevent the Group incurring losses that would impair its ability to operate. The Group's key capital measure is currently its A.M. Best rating. Lancashire's maintenance of a Group AM Best rating of a minimum of A- or higher remains the key determinant of its ability to attract and retain business in the markets in which Lancashire operates. In 2018, Lancashire maintained its A rating.

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

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

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

B.4 Internal control system

(A) Internal control system

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

Internal control can be defined as a continuous set of processes carried out by an entity's Board of Directors, management and all personnel, designed to provide reasonable assurance of:

- Effectiveness and efficiency of operations;
- Reliability of financial and non-financial information;
- Adequate control of risks;
- Prudent approach to controlling the business; and
- Compliance with laws and regulation, and internal policies and procedures.

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

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

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

The key control activities within the Group and its subsidiaries include:

- Approval processes;
- Authorisations;
- Verifications;
- Reconciliations;
- Management reviews;
- Appropriate measurements applicable to each business area;
- Monitoring compliance with agreed exposure limits and operating principles/instructions, and
- Follow-up on any instances of non-compliance.

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

Control Monitoring

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

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

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

(B) Compliance function

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

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

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

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

B.5 Internal audit function

(A) Internal audit function

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

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

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

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

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

(B) Internal audit function: independence and objectivity

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

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

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

B.6 Actuarial function

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

In order to demonstrate independence between performing and reviewing work Lancashire engaged external actuaries during the year to:

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

B.7 Outsourcing

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

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

The Group remains fully responsible for discharging all of its obligations under the rules and other laws, regulations and administrative provisions, and therefore cannot contract out its regulatory obligations and takes care to supervise the discharge of any outsourced functions and/or activities. None of the Group's key or important functions are outsourced; however external service providers are used in certain instances to provide expertise, skills or products that are not available internally. In all instances key and important functions are managed and supervised by Lancashire employees, who retain oversight and responsibility for the functions. With the exception of the underwriting services agreement between KCML, KRL and KHL, as described on page 11 of this document, there are no material intra-group outsourcing arrangements in place within the Group.

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

Internal Audit

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

Actuarial Function

As noted in Section B.6 above, during 2018 the actuarial function has used external actuaries, based in the UK, to provide independent support around aspects of the IFRS and Solvency II technical provision process. The independent actuary also acts as 'Approved Actuary' for the Company and provides the required regulatory opinion on the Company's reserves. This support is not considered to constitute outsourcing of the role or tasks of the Actuarial Function; the responsibility for these is maintained internally.

Finance and Investment Management

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

Investment guidelines are established by the Investment Committee of the Group's Board of Directors; these then determine parameters within which the Group's investment managers must operate. Compliance with the investment guidelines is monitored by the internal investment management team on a monthly basis. Further details regarding the Group's investment guidelines are available in the Investment Risk section of LHL's 31 December 2018 consolidated financial statements, from page 120 of the 2018 Annual Report and Accounts: Investors - Lancashire Group.

IT

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

B.8 Any other information

As noted under Section B1 above, the Group monitors its compliance with the UK Corporate Governance Code on at least a quarterly basis. The Group also monitors its compliance with applicable corporate governance requirements under Bermuda law and regulations. This is facilitated by the Group Company Secretary and the compliance function, which maintains a corporate governance code checklist that is provided to the Nomination and Corporate Governance Committee on a quarterly basis.

A formal performance evaluation of the Board, its Committees and individual Directors is undertaken on an annual basis and the process is initiated by the Nomination and Corporate Governance Committee. The aim of this work is to assess the effectiveness of the Board and its Committees in terms of performance and risk oversight, strategic development, composition, supporting processes and management of the Group. The evaluation is forward-looking in terms of identifying the strategic priorities as well as considering performance, training and development needs for the Directors within the context of the work of each Committee and that of the Board. The 2017 evaluation was conducted internally and facilitated by the Company Secretary and the Chairman and the 2018 performance evaluation process was facilitated by Lintstock Limited, a London-based corporate advisory firm with no other connection to the Group. The report's conclusion was that the Board and each of its Committees are considered to have a balance of skills and perspectives that serve the Group effectively and enable them to meet the challenges of the business.

All material information regarding the Group's system of governance has been described in sections B1-B7 above. The risk management and internal control systems and reporting procedures are implemented consistently in all the undertakings within the scope of group supervision, as required by Article 246 of Directive 2009/138/EC. Given the above assessments, the Group considers its system of governance to be appropriate given the nature, scale and complexity of the risks inherent in its business.

The Group is exposed to risks from several sources. These include underwriting risk, market risk, liquidity risk, credit risk, operational risk and strategic risk. The primary risk to the Group is insurance underwriting risk. There have been no material changes to the Group's material risks or the measures used to assess these risks over the 2018 reporting period.

C.1 Underwriting risk

From an individual entity and at the Group level, underwriting risk continues to dominate our risk profile. It has the highest impact on the regulatory capital requirements of Solvency II and the BMA SCR as well as being the primary driver for our capital decisions – the maintenance of the AM Best rating.

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

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

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

As at 31 December 2018		100 year return period estimated net loss $000	250 year return period $000
Zones	**Perils**		
Gulf of Mexico	Hurricane	108,293	171,359
Non-Gulf of Mexico – U.S.	Hurricane	63,078	166,703
California	Earthquake	36,027	65,974
Pan-European	Windstorm	37,774	50,112
Japan	Typhoon	19,294	26,012
Japan	Earthquake	20,069	46,252
Pacific North West	Earthquake	5,695	35,408

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

Losses in the Group's classes are hard to predict as to the specifics of timing and quantum of occurrence and they can also exceed expectations in terms of both frequency and severity. We recognise that through climate change, weather related events may increase in frequency, severity and clustering, so although the Group models losses, for example using the RMS and AIR stochastic models, Lancashire is cognisant that these projections will be wrong in many instances.

Management uses internal economic capital modelling tools for monitoring its insurance risks. Within these, insurance risk accounts for the majority of the allocated risk capital, so this is the principal area where the Group stringently applies controls and reviews. For example, Lancashire places a large number of controls around monitoring risk levels across the business with the level of insurance risk tolerance per peril set by the respective Boards of Directors at both LHL and entity level.

The RRC reviews the PMLs on a monthly basis and RDSs on a quarterly basis. They are also reported to the Group, LICL and LUK Boards through the quarterly Group CRO reporting. Any projected or actual breach of limits requires immediate action by management, with the risk owner being required to immediately contact the Group CRO with an explanation and mitigating plan. Actual breaches require a mitigating plan, which must be approved by the Group CRO and the Group CEO and are reported to Group management, the RRC and appropriate Board(s). There were no breaches in 2018.

Mitigation

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

- The Group has a rolling three-year strategic plan that helps establish the over-riding business goals that the Board of Directors aims to achieve;
- A detailed business plan is produced annually which includes expected premiums and combined ratios by class and considers risk-adjusted profitability, capital usage and requirements. The plan is approved by the Board of Directors and is monitored, reviewed and updated on an ongoing basis;
- Internal and third party risk models are used to measure occurrence risks, aggregate risks and correlations between classes and other non-insurance risks;
- Each authorised class has a predetermined normal maximum line structure;
- Each underwriter has a clearly defined limit of underwriting authority;
- The Group and individual operating entities have predetermined tolerances on probabilistic and deterministic losses of capital for certain single events;

- Risk levels versus tolerances are monitored on a regular basis;
- A daily underwriting call is held for LICL and LUK to peer review insurance proposals, opportunities and emerging risks;
- Internal and third party risk models are deployed to model catastrophes and resultant losses to the portfolio and the Group; and
- Reinsurance may be purchased to mitigate both frequency and severity of losses on a treaty or facultative basis and to improve risk-adjusted RoE.

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

Use of Special Purpose Vehicles
Although the majority of the Group's reinsurance arrangements are with highly rated counterparties a small number of special purpose vehicles were utilised for outwards reinsurance protection during 2018. These accounted for 8.2% (2017 - 14.1%) of the Group's reinsurance cover purchases. The fully funded principle is met as all the reinsurance protections were fully collateralised up to the limit of the relevant contracts. The collateral can only be released post expiry of the contract with Lancashire's agreement. The special purpose vehicles are registered in Bermuda and are not therefore authorised under Article 211 of the Solvency II Directive.

C.2 Market risk

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

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

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

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

Risk concentration is closely monitored to ensure that there is no excessive concentration with one issuer or issuer group although there is a degree of concentration with the U.S. government and agencies as well as the Group's investment in Kinesis. Total exposure to U.S. government treasury bonds was $361,455 thousand at 31 December 2018, and comprises the only material exposure to a single issuer. Kinesis, given its unrated nature and not immaterial contribution to the Group's assets, also triggers a concentration risk charge. Concentration risk is not a material component (9.1%) of the Group's SCR charge.

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

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

Detailed risk disclosures covering the Group's investment portfolio are included in the LHL's Annual Report and Accounts for 31 December 2018, pages 120-126, 129 and 132 Investors - Lancashire Group.

Mitigation
Our investment risk is mitigated through the following:

- Investment strategy, including investment risk tolerances, is approved annually by the Investment Committee and the Board. A detailed strategic asset allocation study is performed annually;
- Investment Risk and Return Committee: the IRRC forms an integral part of our risk management framework, meeting at least quarterly and reporting to the RRC;
- Diversification: our portfolio is diversified across a number of sectors, geographical areas and types of investment; and

- External advisers: Lancashire's Board and management recognise that the Group's principal expertise lies in underwriting so we use the services of internationally recognised investment managers who are experts in their fields.

Monitoring

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

Currency risk

The 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 profit or loss.

We consider that the currency risk exposure is not sufficiently material to impact upon the resilience of our balance sheet either at a Group or entity level; its impact is limited to its effects on mean returns and the volatility of the same. The Group hedges monetary non-U.S. dollar liabilities primarily with non-U.S. dollar assets, but may also use derivatives to mitigate foreign currency exposures. The Group's main foreign currency exposure relates to its insurance obligations, cash holdings, investments, premiums receivable, dividends payable and the Euro denominated subordinated loan notes.

Mitigation

The Group uses forward foreign currency contracts for the purposes of managing currency exposures. We monitor our currency risk exposure against set tolerances.

Monitoring

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

C.3 Credit risk

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

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

As at 31 December 2018	Financial assets $'000	Receivables and other assets $'000	Reinsurance recoverables $'000
AAA	580,009	—	—
AA+, AA, AA-	121,308	—	—
A+, A, A-	303,236	5,455	44,059
BBB+, BBB, BBB-	202,080	—	—
Other	346,760	17,838	59,094
Total	**1,553,393**	**23,293**	**103,153**

1. Reinsurance recoverables classified as 'other' relate to reinsurers that are fully collateralised.

Reinsurance Counterparty

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

Counterparty credit risk is an immaterial component of our SCR charge – see Section E2 below.

Mitigation

Credit risk on the fixed maturity portfolio is mitigated through the Group's policy to invest in instruments of high credit quality issuers and to limit the amounts of credit exposure with respect to particular ratings categories and any one issuer. Securities rated below an S&P or equivalent rating of BBB-/Baa3 may comprise no more than 15.0% of shareholders' equity. In addition, no one issuer, with the exception of U.S. government and agency securities, other G10 government guaranteed securities (excluding Italy) and Australian sovereign debt should exceed 5.0% of shareholders' equity. The Group is therefore not exposed to any significant credit concentration risk on its investment portfolio, except for fixed maturity securities issued by the U.S. government and government agencies and other highly rated governments.

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

Credit risk on inwards premiums receivable from insureds and cedants is managed by conducting business with reputable broking organisations, with whom the Group has established relationships, and by rigorous cash collection procedures. The Group also has a broker approval process in place. Binding authorities are subject to standard market controls including credit control. Credit risk from reinsurance recoverables is primarily managed by the review and approval of all reinsurer security by the RSC. The RSC monitors the Group's reinsurers on an ongoing basis and formally reviews the Group's reinsurance arrangements at least quarterly.

Monitoring

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

C.4 Liquidity risk

Liquidity risk is the risk that cash may not be available to pay obligations when they are due without incurring an unreasonable cost. The Group's main exposures to liquidity risk are with respect to its insurance and investment activities. The Group is exposed if proceeds from financial assets are not sufficient to fund obligations arising from its insurance contracts. The Group can be exposed to daily calls on its available investment assets, principally to settle insurance claims and to fund trust accounts following a large catastrophe loss.

Exposures in relation to insurance activities are as follows:

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

Exposures in relation to investment activities are as follows:

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

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

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

Mitigation

The 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 and core plus portfolios with their subset of guidelines aims to ensure funds are readily available to meet potential insurance liabilities in an extreme event plus other near-term liquidity requirements. In addition, the Group has established asset allocation and maturity parameters within the investment guidelines such that the majority of the investments are in high quality assets which could be converted into cash promptly and at minimal expense. The Group monitors market changes and outlook and reallocates assets as deemed necessary. We also monitor and report Group liquidity against tolerances to the LHL, LICL and LUK Boards.

Monitoring

The continued effectiveness of the risk mitigation techniques is monitored by the Board's Investment Committee through quarterly investment performance reports and the Board through its review of the quarterly ORSA report plus the quarterly management IRRC meetings. These are described more fully in Section B to this report, above.

Expected profit in future premiums

The total amount of the expected profit included in future premiums as calculated in accordance with Article 260(2) is $99,035 thousand.

C.5 Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes or systems. The Group and its subsidiaries have identified and evaluated their key operational risks and these are incorporated in the risk registers and modelled directly within the subsidiaries' capital models.

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

Mitigation

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

Monitoring

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

C.6 Other material risks

Strategic Risk

The Group has identified several strategic risks. These include:

- The risks that either the poor execution of the business plan or an inappropriate business plan in itself results in a strategy that fails to adequately reflect the trading environment, resulting in an inability to optimise performance, including reputational risk;
- The risks of the failure to maintain adequate capital, accessing capital at an inflated cost or the inability to access capital. This includes unanticipated changes in vendor, regulatory and /or rating agency models that could result in an increase in capital requirements or a change in the type of capital required; and
- The risks of succession planning, staff retention and key man risks.
- The risk that the Group fails to develop a clear strategy to address the UK's proposed withdrawal from the EU ('Brexit'), which following the latest delay is now scheduled to take effect on 31 October 2019 at the latest, and as a result is unable to continue underwriting certain classes of business in the EU27.

Mitigation

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

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

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

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

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

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

Brexit – the Group has addressed the risks associated with Brexit through the following:

- Establishing a solution such that a significant proportion of LUK's existing EU27 business could be written via Lloyd's Brussels, utilising CUL, which has Lloyd's approval for this arrangement, subject to ongoing approval by Lloyd's and any additional approvals of the Belgian regulatory authorities that may be required in relation to the operation of Lloyd's Brussels;
- Established additional intra-group solutions to enable the Group to retain EU27 (re)insurance business; and
- Researched and proposed solutions and provided regular updates to the Board within the quarterly ORSA.

Monitoring
The continued effectiveness of the risk mitigation techniques for other material risk is monitored by the Board through their review of the quarterly ORSA report and the quarterly capital paper. These are described more fully in Section B to this report, above. The Group Board's Nomination and Corporate Governance Committee is responsible for monitoring the adequacy of the Group's succession plans.

Group Risk
Group risks are any risks that may not have an impact at the individual entity level but have to be considered at the group level such as contagion risk or aggregation of business risks. Group risk is considered and evaluated by the LHL Board on a quarterly basis, as is the concentration of risk in each individual risk area (e.g. insurance, credit etc.). There are no significant risk concentrations at the Group level that are not otherwise reported above.

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

C.7 Any other information

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

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

Scenario testing was used to assess the risk, return and capital implications of alternative potential planning scenarios. It was supported by the use of the modelling outputs and applied both within the annual business planning process and on an ad-hoc basis to support the evaluation of potential changes in business strategy. The scenarios were developed with input from across the Group's senior management team and representation from the NED's. The scenarios covered the following key risk areas: insurance risk, investment risk (liquidity risk) and regulatory risk.

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

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

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

D.1 Assets

(A) Value of assets

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

As at 31 December	2018 $'000
Deferred tax assets	1,098
Property, plant & equipment	1,363
Investments (excluding participations)	1,380,270
Participations	45,925
Loans & mortgages	109,239
Reinsurance recoverables	103,153
Insurance and intermediaries receivables	12,441
Reinsurance receivables	5,455
Receivables (trade, not insurance)	4,106
Own shares	8,697
Cash and cash equivalents	63,884
Any other assets, not elsewhere shown	1,291
Total assets	**1,736,922**

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

Financial assets

Financial assets comprise the following:

As at 31 December	2018 $'000
Bonds	
Government bonds	381,513
Corporate bonds	567,412
Structured notes	45,154
Collateralised assets	149,355
Collective investment undertakings	234,816
Derivative assets	2,020
Investments (excluding participations)	**1,380,270**
Loans and mortgages	109,239
Cash and cash equivalents	63,884
Total financial assets	**1,553,393**

With the exception of cash and cash equivalents and money market funds of $38,583 thousand included within collective investment undertakings, financial assets are held at fair value. 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. In accordance with their pricing policy, various recognised reputable pricing sources are used including broker-dealers and pricing vendors. The pricing sources use bid prices where available, otherwise indicative prices are quoted based on observable market trade data. The prices provided are compared to the investment managers' pricing. The Group has not made any adjustments to any pricing provided by independent pricing services or its third-party investment managers for the year ended 31 December 2018.

Highly liquid U.S. government treasury bonds and certain highly liquid short-term investments, included within the Solvency II government bonds caption, are considered to be quoted in an active market, with quoted prices readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Excepting collective investment undertakings and cash, the remainder of the Group's financial assets are securities with quoted prices in active markets valued in accordance with the methods described in more detail on pages 143-145 of LHL's Annual Report and Accounts for 31 December 2018: Investors - Lancashire Group.

Collective investment undertakings comprise hedge funds and money market funds. The fair values of the Group's hedge funds are determined using a combination of the most recent NAVs provided by each fund's independent administrator and the estimated performance provided by each hedge fund manager. Independent administrators provide monthly reported NAVs with up to a one-month delay in valuation. The most recent NAV available for each hedge fund is adjusted for the estimated performance, as provided by the fund manager, between the NAV date and the reporting date. Historically estimated fair values incorporating these performance estimates have not been significantly different from subsequent NAVs. Given the Group's knowledge of the underlying investments and the size of the Group's investment therein, we would not anticipate any material variance between estimated valuations and the final NAVs reported by the administrators.

Money market funds and cash and cash equivalents are carried at carrying value. Carrying amounts approximate fair value due to the short-term nature and high liquidity of the instruments.

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

Participations - Related undertakings

As at 31 December	2018 $'000
Kinesis	67,079
Cathedral Group	(21,154)
Total participations	**45,925**

The investment in Kinesis is accounted for as an associate and was originally recognised at cost and thereafter accounted for using the equity method. This valuation is not materially different from the estimated Solvency II valuation for Kinesis.

The investment in the Cathedral Group is carried at the Solvency II net asset value, excluding intra-group balances.

For both of these participations the use of quoted market prices for valuation purposes was not possible as they are not traded on an active market.

Deferred tax

As at 31 December	2018 $'000
Restricted shares	2,529
Capital allowances	1,358
Claims Equalisation Reserves	(959)
Solvency II valuation adjustment	(2,056)
Other	226
Total deferred tax	**1,098**

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

The UK corporation tax rate as at 31 December 2018 was 19%. The UK government has passed legislation to reduce the rate of corporation tax to 17% with effect from 1 April 2020. These rates have been reflected in the closing deferred tax position on the balance sheet.

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

Other assets

Other assets comprise the following:

As at 31 December	2018 $'000
Property, plant & equipment	1,363
Insurance and intermediaries receivables	12,441
Reinsurance receivables	5,455
Receivables (trade, not insurance)	4,106
Own shares	8,697
Any other assets, not elsewhere shown	1,291
Total other assets	**33,353**

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

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

Reinsurance recoverables

The valuation of reinsurance recoverables is disclosed in Section D.2 below.

Operating leases

The Group's operating lease arrangements are disclosed in section D.3(A) below.

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

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

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

The use of estimates in the valuation of the Group's investment portfolio and derivatives is disclosed on pages 105 and 107-108 of LHL's 31 December 2018 consolidated financial statements included in the 2018 Annual Report and Accounts, available on the Group's website here: Investors - Lancashire Group.

(B) Differences between value for solvency purposes and value for financial statements

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

As at 31 December 2018 ($'000)	IFRS financial statements	IFRS excluding Cathedral	Solvency II	Total difference, excluding Cathedral impact	Presentation differences	Valuation differences
Deferred acquisition costs [1]	74,233	50,911	—	(50,911)	—	(50,911)
Goodwill and intangible assets	153,757	—	—	—	—	—
Deferred tax assets	—	3,154	1,098	(2,056)	—	(2,056)
Property, plant & equipment	1,363	1,363	1,363	—	—	—
Investments (including loans and mortgages) [2]	1,659,375	1,476,494	1,489,509	13,015	13,015	—
Participations	67,079	45,925	45,925	—	—	—
Reinsurance recoverables [1]	379,665	240,856	103,153	(137,703)	(107,835)	(29,868)
Insurance and intermediaries receivables [1]	318,091	218,422	12,441	(205,981)	(205,981)	—
Reinsurance receivables [1]	9,773	1,327	5,455	4,128	4,128	—
Receivables (trade, not insurance)	—	—	4,106	4,106	4,106	—
Own shares [3]	—	—	8,697	8,697	9,424	(727)
Cash and cash equivalents [2]	154,655	65,034	63,884	(1,150)	(1,150)	—
Any other assets, not elsewhere shown [2]	41,930	19,440	1,291	(18,149)	(18,149)	—
Total assets	**2,859,921**	**2,122,926**	**1,736,922**	**(386,004)**	**(302,442)**	**(83,562)**

1. These adjustments are all related to the Solvency II technical provisions calculation – see Section D.2 below.
2. These presentation differences are due to alternative classification of financial assets under the Solvency II regulations, including the treatment of accrued interest and pending trades that are included in 'other assets' on an IFRS basis and within the relevant investment asset classification on a Solvency II basis. These presentation re-allocations have no impact on the Group's Own Funds.
3. Own shares are reclassified from shareholders' equity on an IFRS basis to assets on a Solvency II basis and are then excluded from the Own Funds calculation. This presentation and valuation difference therefore has no impact on the Group's Own Funds.

D.2 Technical provisions

(A) Value of technical provisions

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

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

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

As at 31 December 2018 ($'000)	Marine, aviation and transport insurance	Fire and other damage to property insurance	Credit and suretyship insurance	Non-proportional marine, aviation and transport reinsurance	Non-proportional property reinsurance	Total
Best estimate premium provisions						
• Gross	1,310	(13,894)	(28,735)	(7,278)	(47,118)	**(95,715)**
• Reinsurance recoverables	51,857	10,820	(14,375)	4,410	37,790	**90,502**
Net best estimate of premium provision	53,167	(3,074)	(43,110)	(2,868)	(9,328)	**(5,213)**
Best estimate claims provision						
• Gross	200,678	66,458	21,939	29,149	226,357	**544,581**
• Recoverables from reinsurance	(89,736)	(15,609)	(7,407)	(637)	(80,266)	**(193,655)**
Net best estimate of claims provisions	110,942	50,849	14,532	28,512	146,091	**350,926**
Risk margin	11,474	4,919	2,700	5,598	27,924	**52,615**
Total technical provisions	**175,583**	**52,694**	**(25,878)**	**31,242**	**164,687**	**398,328**

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

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

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

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

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

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

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

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

(B) Level of uncertainty in valuation of technical provisions

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

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

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

(I) Uncertainty within the claims provisions

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

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

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

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

(II) Uncertainty within the premium provisions

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

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

(C) Differences between value for solvency purposes and value for financial statements

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

As at 31 December 2018 ($'000)	Gross of Reinsurance	Reinsurance	Net of Reinsurance
Loss reserves and unearned premium reserves	835,641	(240,856)	594,785
Deferred acquisition costs	(50,911)	7,048	(43,863)
i) Technical provisions – accounting basis*	**784,730**	**(233,808)**	**550,922**
ii) Movement of not yet due premium debtors and creditors to TPs	(181,539)	49,876	(131,663)
Total reclassification difference	**(181,539)**	**49,876**	**(131,663)**
iii) Adjustments to IFRS loss reserves for basis change	(24,076)	(3,108)	(27,184)
iv) Profit in respect of legally obliged future exposure	(105,365)	72,101	(33,264)
v) Allowance for reinsurer default	—	144	144
vi) Allowance for discounting at risk free rates	(24,884)	11,642	(13,242)
vii) Risk margin	52,615	—	52,615
Total valuation difference	**(101,710)**	**80,779**	**(20,931)**
Technical provisions – solvency basis	**501,481**	**(103,153)**	**398,328**

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

The adjustments made to the valuation of technical provisions in the IFRS consolidated financial statements to determine the valuation for solvency purposes are the same for each Solvency II line of business and are described below:

(I) IFRS provisions

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

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

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

The Group engages an external actuary to conduct an independent review of the Group's claims reserves on an IFRS basis every six months.This analysis is included for comparison in the IBNR report to the Audit Committee. Significant differences between the two estimates are discussed in the report.

(II) Movement of not yet due premium debtors to technical provisions

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

(III) Adjustments to ifrs loss reserves for basis change

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

Adjustment to actuarial best estimate

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

Allowance for events not in data ('ENIDs')

The IFRS technical provisions allow for the best estimate of ‘reasonably foreseeable’ outcomes whereas Solvency II requires the best estimate of ‘all possible outcomes’. This implicitly includes a wider range of events in the future claim estimates and introduces the concept of an ENID allowance in the solvency provisions. The ENID allowance may include latent claims or very extreme high severity/low probability claims but more widely any event not observed in the historical data. An ENID uplift is added to the claims provision for Solvency II to recognise the difference between IFRS and Solvency II bases. Given the generally short reporting and settlement periods of the business written by the Group the provision for ENIDs within the claims provisions (i.e. in respect of events which have occurred) is expected to be lower than the equivalent ENID allowance within the premium provision (see IV below).

ENID uplift ratios are calculated separately for each line of business and are applied to the claims provisions. The ratios are calculated using the ratio of the mean of the full range of reserve risk outcomes from Lancashire’s capital model, BLAST, to the mean of a range where outcomes above the 99th percentile are truncated. This therefore allows for modelled events over the 1 in 100 outcome level. The same uplift proportions are applied gross and net of reinsurance.

Inclusion of additional expenses

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

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

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

(IV) Profit in respect of legally obliged future exposure

Profit in respect of legally obliged future exposure comprises of the following:

Removal of UPR and DAC

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

Inclusion of claims associated with UPR

Gross and net premium provisions are calculated using expected ultimate ratios by line of business applied to the unearned premium. The loss ratios are sourced from the business plan and represent the best estimate view (i.e. mean of the distribution of future outcomes) of the losses likely to emerge in future periods and as such are deemed a reasonable assumption to use. The ENID uplift, see below, is applied to these ratios to move this to an 'all outcomes' basis.

Inclusion of future reinsurance premium covering future exposure on existing legal obligations

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

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

Allowance for events not in data

Similar to the claims provisions (as described in III above), an ENID allowance is also added to the premium provision. This is done using a similar set of assumptions and processes to the claims provisions (i.e. truncating the BLAST distributions at the 99th percentile for each class of business). However, given the higher uncertainty in the premium provisions, the allowance for ENIDs is generally proportionally greater than the claims provisions.

Future cashflow from unincepted legal obligations

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

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

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

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

(V) Allowance for reinsurer default

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

Use of simplified method

The following assumptions are made to derive the allowance:

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

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

(VI) Allowance for discounting at risk free rates

The undiscounted future claim, premium and expense amounts are derived, as described above, by class of business and the most material currencies. The material currencies are assessed prior to each valuation based on an assessment of the existing claims and exposure. At 2018 year-end the provisions were derived explicitly in fourteen separate currencies. All non-material currencies are grouped together and discounted using a U.S. dollar risk-free yield curve.

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

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

(VII) Risk margin

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

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

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

Use of simplified method

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

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

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

(VIII) Other cashflows

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

(D) Differences between value for solvency purposes and value for financial statements by solvency ii lines of business

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

Marine, aviation & transport insurance As at 31 December 2018 ($'000)	Gross of Reinsurance	Reinsurance	Net of Reinsurance
i) Technical provisions – accounting basis*	**267,855**	**(94,071)**	**173,784**
ii) Movement of not yet due premium debtors and creditors to TPs	(34,461)	31,660	(2,801)
Total reclassification difference	**(34,461)**	**31,660**	**(2,801)**
iii) Adjustments to IFRS loss reserves for basis change	(6,844)	(4,568)	(11,412)
iv) Profit in respect of legally obliged future exposure	(14,231)	22,461	8,230
v) Allowance for reinsurer default	—	75	75
vi) Allowance for discounting at risk free rates	(10,331)	6,564	(3,767)
vii) Risk margin	11,474	—	11,474
Total valuation difference	**(19,932)**	**24,532**	**4,600**
Technical provisions – solvency basis	**213,462**	**(37,879)**	**175,583**

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

Fire and other damage to property insurance As at 31 December 2018 ($'000)	Gross of Reinsurance	Reinsurance	Net of Reinsurance
i) Technical provisions – accounting basis*	**100,618**	**(20,767)**	**79,851**
ii) Movement of not yet due premium debtors and creditors to TPs	(23,269)	8,348	(14,921)
Total reclassification difference	**(23,269)**	**8,348**	**(14,921)**
iii) Adjustments to IFRS loss reserves for basis change	2,190	380	2,570
iv) Profit in respect of legally obliged future exposure	(23,918)	6,538	(17,380)
v) Allowance for reinsurer default	—	11	11
vi) Allowance for discounting at risk free rates	(3,057)	701	(2,356)
vii) Risk margin	4,919	—	4,919
Total valuation difference	**(19,866)**	**7,630**	**(12,236)**
Technical provisions – solvency basis	**57,483**	**(4,789)**	**52,694**

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

Credit & suretyship insurance As at 31 December 2018 ($'000)	Gross of Reinsurance	Reinsurance	Net of Reinsurance
i) Technical provisions – accounting basis*	**98,056**	**(28,209)**	**69,847**
ii) Movement of not yet due premium debtors and creditors to TPs	(59,043)	1,514	(57,529)
Total reclassification difference	**(59,043)**	**1,514**	**(57,529)**
iii) Adjustments to IFRS loss reserves for basis change	(1,341)	(361)	(1,702)
iv) Profit in respect of legally obliged future exposure	(41,731)	3,716	(38,015)
v) Allowance for reinsurer default	—	21	21
vi) Allowance for discounting at risk free rates	(2,737)	1,537	(1,200)
vii) Risk margin	2,700	—	2,700
Total valuation difference	**(43,109)**	**4,913**	**(38,196)**
Technical provisions – solvency basis	**(4,096)**	**(21,782)**	**(25,878)**

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

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

Non-proportional marine, aviation & transport Reinsurance As at 31 December 2018 ($'000)	Gross of Reinsurance	Reinsurance	Net of Reinsurance
i) Technical provisions – accounting basis*	**36,532**	**(3,629)**	**32,903**
ii) Movement of not yet due premium debtors and creditors to TPs	(11,936)	(2,557)	(14,493)
Total reclassification difference	**(11,936)**	**(2,557)**	**(14,493)**
iii) Adjustments to IFRS loss reserves for basis change	2,408	(29)	2,379
iv) Profit in respect of legally obliged future exposure	(3,130)	10,017	6,887
v) Allowance for reinsurer default	—	1	1
vi) Allowance for discounting at risk free rates	(2,003)	(30)	(2,033)
vii) Risk margin	5,598	—	5,598
Total valuation difference	**2,873**	**9,959**	**12,832**
Technical provisions – solvency basis	**27,469**	**3,773**	**31,242**

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

Non-proportional property Reinsurance As at 31 December 2018 ($'000)	Gross of Reinsurance	Reinsurance	Net of Reinsurance
i) Technical provisions – accounting basis*	**281,669**	**(87,132)**	**194,537**
ii) Movement of not yet due premium debtors and creditors to TPs	(52,830)	10,911	(41,919)
Total reclassification difference	**(52,830)**	**10,911**	**(41,919)**
iii) Adjustments to IFRS loss reserves for basis change	(20,489)	1,470	(19,019)
iv) Profit in respect of legally obliged future exposure	(22,355)	29,369	7,014
v) Allowance for reinsurer default	—	36	36
vi) Allowance for discounting at risk free rates	(6,756)	2,870	(3,886)
vii) Risk margin	27,924	—	27,924
Total valuation difference	**(21,676)**	**33,745**	**12,069**
Technical provisions – solvency basis	**207,163**	**(42,476)**	**164,687**

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

E) Prescribed statements

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

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

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

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

(F) Recoverables

Reinsurance recoverables consist of amounts due from reinsurers for third party reinsurance. They comprise reinsurers' share of premium and claims provisions both in respect of future premium and claim amounts.

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

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

(G) Material changes in calculation assumptions

The following material changes have been made to the Solvency II Technical Provision process and methods since 31 December 2017:

- Events Not In Data - the process to convert IFRS to Solvency II basis provisions now incorporates a specific ENID allowance within the claims provisions to reflect market best practice. This follows the change at 31 December 2017 to recognise a difference between management and actuarial best estimates within the future claim estimates.
- Provision for future General & Administrative expenses - the annual G&A costs are now assumed to reduce proportionally in line with the reduction in reserves. At previous valuations the G&A provision reduced at a slower rate than the claims reserves however, this was felt to be out of line with market practice and overly conservative.

D.3 Other liabilities

(A) Value of liabilities

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

As at 31 December	2018 $'000
Technical Provisions	501,481
Derivatives	2,678
Financial liabilities other than debts owed to credit institutions	137,343
Insurance & intermediaries payables	922
Payables (trade, not insurance)	30,972
Subordinated liabilities	96,687
Total Liabilities	**770,083**

(I) Financial liabilities and subordinated liabilities

Financial liabilities, other than debts owed to credit institutions and subordinated liabilities, comprise the Group's long-term debt (excluding that issued by Cathedral). Long-term debt is recognised initially at fair value, net of transaction costs incurred. Upon subsequent measurement the financial liabilities are measured at fair value excluding movements in the issuer's own credit standing.

Further details of the Group's long-term debt, including its estimated fair value, is disclosed in Note 17: Long-term Debt and Financing Arrangements of LHL's 31 December 2018 consolidated financial statements on pages 153 to 155 of LHL's 2018 Annual Report and Accounts, see website: Investors - Lancashire Group.

(II) Other liabilities

All other liabilities are valued for Solvency II purposes on the same basis as for IFRS accounting purposes since the carrying value approximates economic value due to their short-term nature. The maturity profile of the Group's other liabilities is as follows:

		Years until liability becomes due – undiscounted values				
As at 31 December 2018	Balance sheet $'000	Less than one $'000	One to three $'000	Three to five $'000	Over five $'000	Total $'000
Derivatives	2,678	2,424	254	—	—	2,678
Insurance and intermediaries payables	922	922	—	—	—	922
Payables (trade, not insurance)	30,972	30,972	—	—	—	30,972
Financial liabilities and subordinated liabilities	234,030	12,157	29,113	151,823	198,630	391,723
Total	**268,602**	**46,475**	**29,367**	**151,823**	**198,630**	**426,295**

Actual maturities of the above may differ from contractual maturities because certain borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties. The Group has the option to redeem its senior unsecured notes and all of its subordinated loan notes, in whole or in part, prior to the respective maturity dates.

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

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

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

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

Leasing arrangements

The Group has payment obligations in respect of operating leases for certain items of office equipment and office space. Operating lease expenses are charged to income on a straight-line basis over the lease term. Future minimum lease payments under non-cancellable operating leases are disclosed in Note 21 of LHL's 31 December 2018 consolidated financial statements included in the 2018 Annual Report and Accounts, available on the Group's website here: Investors - Lancashire Group.

With effect from 1 January 2019 the Group will adopt IFRS 16 for lease accounting. Further information on the impact this will have on the Group is disclosed in future accounting changes in the accounting policies in LHL's 31 December 2018 consolidated financial statements included in the 2018 Annual Report and Accounts, available on the Group's website here: Investors - Lancashire Group.

Deferred tax liabilities

There is no net deferred tax liability on the Solvency II balance sheet. The treatment and recognition of deferred tax assets is discussed in sections D.1(A) and D.1(B) above.

Liabilities for employee benefits

The Group's does not have any material liabilities for employee benefits and does not have a defined benefit pension scheme.

(B) Differences between value for solvency purposes and value for financial statements

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

As at 31 December 2018 ($'000)	IFRS financial statements	IFRS excluding Cathedral	Solvency II	Total difference, excluding Cathedral impact	Presentation differences	Valuation differences
Technical provisions	1,285,700	835,641	501,481	(334,160)	(239,498)	(94,662)
Deferred tax liabilities	11,234	—	—	—	—	—
Derivatives	702	702	2,678	1,976	1,976	—
Financial liabilities other than debts owed to credit institutions	130,000	130,000	137,343	7,343	1,852	5,491
Insurance & intermediaries payables	35,975	24,442	922	(23,520)	(23,520)	—
Reinsurance payable	81,247	45,739	—	(45,739)	(45,739)	—
Payables (trade, not insurance)	46,101	38,250	30,972	(7,278)	(7,278)	—
Subordinated liabilities	194,340	124,474	96,687	(27,787)	341	(28,128)
Any other liabilities, not elsewhere shown	7,099	7,048	—	(7,048)	—	(7,048)
Total liabilities	**1,792,398**	**1,206,296**	**770,083**	**(436,213)**	**(311,866)**	**(124,347)**

The key differences in liabilities between the Solvency II balance sheet and the IFRS basis, after the exclusion of the Cathedral balances, are largely related to the valuation of technical provisions as further analysed in the technical provisions section above, and the financial and subordinated liabilities as noted in section D.3A above.

D.4 Alternative methods for valuation

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

D.5 Any other information

The bases, methods and main assumptions used at the Group level for the Solvency II valuation of the Group's assets, technical provisions and other liabilities do not differ materially from the methods used by the Group's subsidiaries.

The Group has a commitment of $100,000 thousand in respect of two credit facility funds. The Group, via the funds, provides collateral for revolving credit facilities purchased at a discount from financial institutions and is at risk for its portion of any defaults on those revolving credit facilities. The Group's proportionate share of these revolving credit facilities purchased by the funds as at 31 December 2018 is $54,400 thousand, which currently remains unfunded. The maximum exposure to the credit facility funds is $100,000 thousand and as at 31 December 2018 there have been no defaults under these facilities.

All material information regarding the valuation of assets and liabilities for solvency purposes has been disclosed in sections D.1-D.4 above.

E.1 Own funds

(A) Management of own funds

The Group actively reviews the level and composition of capital on an ongoing basis. Decisions on optimal capital levels are also an integral part of the business planning process which covers a 3 year time horizon. Internal methods have been developed to review the profitability of classes of business and their estimated capital requirements plus the capital requirements of the combination of a wide range of other risk categories.

The key aim of the capital management process is to maintain a strong balance sheet, whilst:

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

The subsidiary operating entities also conduct capital requirement assessments under internal measures and in compliance with local regulatory and Lloyd's requirements. Capital raising can include debt or equity, and returns of capital may be made through dividends, share repurchases, a redemption of debt or any combination thereof. All capital actions require approval by the Board of Directors. The retention of earnings generated also leads to an increase in capital.

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

There have been no material changes in the approach to capital management over the reporting period. The Group uses Method 1, as referred to in Articles 230 and 233 of Directive 2009/138/EC, to calculate the Group's Own Funds and solvency requirement. All Group Own Funds are calculated net of intra-group transactions. There are no Group companies that are entities in other financial sectors.

Own Funds available to meet the SCR at the Group level are subject to an availability assessment comprising two dimensions - fungibility and transferability:

- Fungibility at the Group level means that an element of Own Funds can fully absorb any kind of losses within the Group, regardless of the undertaking within which those Own Funds are held or where commitments arise (in compliance with the local prudential and legal rules); and
- Transferability refers to the ability to transfer Own Funds from one undertaking to another within the Group.

Each solvency assessment considers a number of factors, including:

- The Own Funds under consideration are fungible at the Group level and transferable at the same time;
- The solvency position of the transferor after a possible transfer of Own Funds;
- The extent to which Own Funds can be transferred from an entity to another one without prejudicing the ability to meet policyholder claims or damaging its business; and
- The extent to which legal and regulatory restrictions can put barriers to the movements of Own Funds.

Own Funds that cannot be made either fungible or transferable for the group within a maximum of nine months cannot be considered to be available at the Group level. Own Funds that are restricted at the Group level are detailed in section E.1 F below.

(B) Structure, amount and quality of own funds by tier

Of the Group's Own Funds, totalling $662,906 thousand as at 31 December 2018 (2017 - $830,840 thousand) 99.8% (2017 - 99.8%) comprised Tier 1 capital items. Tier 1 capital is the highest quality capital under Solvency II with the greatest loss absorbing capacity, comprising share capital and retained earnings. There have been no changes to the profile of the components of the Group's Own Funds during the year ended 31 December 2018. The Tier 3 item comprises the Group's net deferred tax asset. Total basic eligible Own Funds of the Group as at 31 December 2018 amounted to $662,906 thousand. The Group's Own Funds are comprised of:

As at 31 December	**2018 $'000**	2017 $'000	Difference $000
Tier 1 Capital			
Ordinary share capital	100,971	100,671	300
Reconciliation reserve	561,152	728,714	(167,562)
Minority interests	(315)	(258)	(57)
Total basic eligible own Funds to meet MCR	**661,808**	**829,127**	**(167,319)**
Tier 3 Capital			
Deferred tax asset	1,098	1,713	(615)
Total basic eligible Own Funds to meet SCR	**662,906**	**830,840**	**(167,934)**

Ordinary share capital comprises allocated, called up and fully paid ordinary shares. Ordinary share capital is the highest quality of capital available and does not have a duration. LHL's bye-laws allow for the cancellation of any dividend or distribution at any point prior to its payment if such actions may be necessary or appropriate:

a) as a result of any applicable law or regulation; or

b) in order otherwise to meet any capital or solvency requirement applicable to the Company or any member of the Group.

Minority interests comprise members of the Group's senior management team's investments in KCML. Having considered the materiality of the balance, the minority interest of $315 thousand has been fully deducted from Own Funds.

The Group does not have any ancillary Own Funds.

The key elements of the reconciliation reserve are as follows:

As at 31 December	2018 $'000	2017 $'000	Difference $000
Total assets (section D1)	1,736,922	1,836,445	(99,523)
Total liabilities (section D3)	(770,083)	(856,275)	86,192
Excess assets over liabilities ("Own Funds")	966,839	980,170	(13,331)
Share capital	(100,971)	(100,671)	(300)
Own shares	(8,697)	(12,100)	3,403
Non-available Own Funds	(294,921)	(136,972)	(157,949)
Total reconciliation reserve and deferred tax asset	**562,250**	**730,427**	**(168,177)**

The reduction in the excess of assets over liabilities of $13,331 thousand is due to:

For the year ended 31 December	2018 $'000
IFRS comprehensive income for the year	24,708
Net movement in other equity reserves (including own shares)	2,511
Dividends paid	(70,230)
Valuation adjustments relating to Financial liabilities other than debts owed to credit institutions and Subordinated liabilities	25,684
Valuation adjustments relating to Deferred Tax	(1,376)
Changes in the movement of technical provisions to a Solvency II basis	4,916
Changes in the adjustment of the Cathedral entities to a Solvency II basis	456
Change in the excess of assets over liabilities	**(13,331)**

The increase in non-available Own Funds is detailed in Section E.1.F below.

The Group's Own Funds are wholly eligible to meet the Solvency Capital Requirements and Minimum Capital Requirement. Furthermore, all Tier 1 capital is permanently available to cover losses. The Group's Own Funds are calculated net of all intra-group transactions.

The Group's subordinated and senior debt does not meet the specific Solvency II eligible capital requirements and is therefore not classified as an Own Funds item. The Group's debt is classified as capital for rating agency and internal capital management purposes.

(C) Eligible own funds to cover SCR by tier

The total Tier 1 and Tier 3 Own Funds of $662,906 thousand (2017 - $830,840 thousand) are eligible to cover the SCR.

(D) Eligible own funds to cover MCR by tier

The total Tier 1 Own Funds of $661,808 thousand (2017 - $829,127 thousand) are eligible to cover the MCR.

(E) Reconciliation of excess of asset over liabilities on a SII basis and shareholders' equity on an IFRS basis

Solvency II Own Funds represent the excess of Solvency II assets over liabilities, adjusted for 'non-available' own fund items. The reconciliation of the IFRS valuation of shareholders' equity to the Solvency II valuation of Own Funds is shown below:

As at 31 December	2018 $'000	2017 $'000	Difference $000
IFRS shareholders' equity	**1,067,523**	**1,107,131**	**(39,608)**
Impact of restating Cathedral on a Solvency II basis	(150,893)	(151,349)	456
Valuation adjustments relating to financial liabilities other than debts owed to credit institutions and subordinated liabilities	22,637	(3,047)	25,684
Valuation adjustments relating to deferred tax	(2,056)	(680)	(1,376)
Valuation adjustments relating to technical provisions	20,931	16,015	4,916
Solvency II Own Funds	**958,142**	968,070	(9,928)
Non-available Own Funds	(294,921)	(136,972)	(157,949)
Minority interest	(315)	(258)	(57)
Solvency II eligible Own Funds	**662,906**	**830,840**	**(167,934)**

As already described above the Cathedral entities are not fully consolidated on a line-by-line basis for Solvency II purposes. The removal of the IFRS consolidated valuation of Cathedral on an IFRS basis includes the elimination of $153,757 thousand (2017 - $153,757 thousand) of intangible assets created on the acquisition of Cathedral in 2013, offset by related deferred tax liability balances of $12,637 thousand (2017 - $12,701 thousand). The remaining difference of $9,773 thousand (2017 - $10,293 thousand) is due to the re-presentation of the value of Cathedral's net assets on a Solvency II equivalent basis.

The valuation adjustments relating to technical provisions are detailed in Section D.2.C above and non-available Own Funds are detailed in Section E.1.F below.

(F) Deductions from own funds

Solvency II requires an adjustment to be made to Own Funds to allow for assets that may be restricted and therefore not available to meet risks and/or liabilities at the Group level. The Groups's non-available Own Funds comprise the following:

As at 31 December	2018 $'000	2017 $'000	Difference $000
FAL (provided by LICL)	242,815	97,294	145,521
Assets pledged to collateralise letters of credit	33,531	28,490	5,041
Collateralised policies	12,877	10,191	2,686
Other	5,698	997	4,701
Solvency II non-available Own Funds	**294,921**	**136,972**	**157,949**

The non-available Own Funds represent funds in related subsidiary undertakings with restrictions on their transferability and fungibility. Notable changes from the December 2017 position are:

(i) Funds at Lloyd's (provided by LICL)

The Group's underwriting capacity in its Lloyd's syndicates must be supported by providing a deposit in the form of cash, securities or LOCs, which are referred to as FAL. The capital framework at Lloyd's requires each managing agent to calculate the capital requirement for each syndicate they manage. Solvency II internal models are used to determine capital requirements for Syndicate 2010 and Syndicate 3010 based on the uSCR. Lloyd's has the discretion to take into account other factors at syndicate or member level to uplift the calculated uSCR. This may include perceived deficiencies in the internal model result as well as the need to maintain Lloyd's overall security rating. Currently, as a minimum, Lloyd's applies a 35.0% uplift to each syndicate's uSCR to arrive at the ECA.

Lloyd's then uses each syndicate's ECA as a basis for determining member level capital requirements, which is backed by FAL. For the 2019 calendar year the Group's corporate member's FAL requirement was set at 67.8% (2018 – 66.5%) of underwriting capacity supported. Further solvency adjustments are made to allow for open year profits and losses of the syndicates on which the corporate member participates. FAL requirements are formally assessed twice a year and any funds surplus to requirements may be released at that time.

The FAL assets provided by LICL are deemed to constitute a material ring fenced fund. There are no other assets or liabilities in this fund. The restriction on the FAL assets is reduced by the SCR charge thereon. During 2017, a LOC of $130,000 thousand was entered into to partially support LICL's FAL contribution. This reduced the pledged assets in the ring fenced fund thereby reducing the Group's restriction on Own Funds. During 2018 the LOC was not renewed at expiry which accounts for the increase in restricted assets relating to the FAL requirement at 31 December 2018. Due to the full consolidation of the Group's Lloyds operations under the BMA model, there was no benefit to Own Funds of renewing the FAL LOC.

(G) Additional information on group own funds

All relevant information concerning the Group's Own Funds has been provided above.

E.2 Solvency capital requirement and minimum capital requirement

(A) SCR and MCR

Lancashire's SCR as at 31 December 2018 is $535,061 thousand and its MCR, being the minimum for the Group's SCR, is $124,171 thousand. With eligible Own Funds of $662,906 thousand, the SCR coverage ratio is 123.9%. The final amount of the SCR as at 31 December 2018 is still subject to supervisory assessment. The Group does not utilise any Undertaking Specific Parameters in accordance with Article 110 of the Solvency II Directive.

(B) SCR split by risk module

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

As at 31 December 2018	Group (remaining part) $'000	FAL RFF $'000	MBRT RFF $'000	Holdings in related undertakings $'000	Total $'000
Underwriting risk	288,776	—	85,630	—	374,406
Market risk	146,863	25,041	1,680	45,105	218,689
Counterparty default risk	17,287	39	1,468	—	18,794
Operational risk	10,203	—	3,574	—	13,777
Undiversified Solvency Capital Requirement	**463,129**	**25,080**	**92,352**	**45,105**	**625,666**
Diversification credit	88,610	29	1,966	—	90,605
Solvency capital requirement for undertakings under consolidated method	**374,519**	**25,051**	**90,386**	**45,105**	**535,061**

Section C of this report includes a detailed qualitative description of these risk modules.

Diversification benefits

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

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

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

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

(C) Standard formula simplifications

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

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

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

(D) MCR inputs

The LUK MCR targets an 80% VaR over a one-year time horizon and is based on proportions of net written premium in the previous 12 months and net best estimate of technical provisions at the valuation date. These are supplied by Solvency II class of business with the proportions varying by class. The LUK MCR is set with reference to a 25% - 45% collar around the SCR, which applies to LUK's calculation; as such LUK's MCR moves in line with the SCR. The Group MCR, representing the minimum for the Group's SCR in accordance with Article 331 2(b)(i) of the Solvency II delegated regulation, is the sum of the LUK and LICL MCRs; the LICL MCR being calculated under the BMA's BSCR model.

The components of the Group MCR are as follows:

As at 31 December	2018 $'000	2017 $'000
LUK MCR	22,464	21,823
LICL MCR	101,707	112,653
Group MCR	**124,171**	**134,476**

(E) Material changes in the SCR and MCR over the reporting period

The components of the SCR as at 31 December 2018 compared to 31 December 2017 are detailed below:

As at 31 December	2018 $'000	2017 $'000	Difference $'000
Underwriting risk	374,406	417,459	(43,053)
Market risk	218,689	225,163	(6,474)
Counterparty default risk	18,794	30,695	(11,901)
Operational risk	13,777	15,309	(1,532)
Undiversified Solvency Capital Requirement	**625,666**	**688,626**	**(62,960)**
Diversification credit	90,605	109,303	(18,698)
Solvency Capital Requirement	**535,061**	**579,323**	**(44,262)**
Minimum Capital Requirement	**124,171**	**134,476**	**(10,305)**

As noted in Section C1 of this report, underwriting risk dominates our risk profile. The reduction observed over 2018 is as a result of:

- Lower underwriting risk as a result of reduced reserve and premium volumes as well as lower man-made catastrophe risk as a result of a change in interpretation of risks included in the gross exposures;
- Lower market risk due to reduced hedge fund exposure plus a lower charge on these funds at 2018 year-end; and
- Lower counterparty default risk due to lower reinsurance recoveries and a reduction in aged receivables over 2018.

E.3 Use of the duration-based equity risk sub-module in the calculation of the solvency capital requirement

The duration-based equity risk sub-module is not being used in the Group's SCR calculation. The UK has elected not to adopt this provision.

E.4 Differences between the standard formula and any internal model used

The Group does not have an approved internal model to calculate its SCR and therefore this section is not applicable.

E.5 Non-compliance with the minimum capital requirement and non-compliance with the solvency capital requirement

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

E.6 Any other information

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

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

All material information regarding the valuation of assets and liabilities for solvency purposes has been disclosed in sections E.1- E.5 above.

APPENDIX 1: ANNUAL QUANTITATIVE REPORTING TEMPLATES

See attached annual QRTs

APPENDIX 2: GLOSSARY

Additional Case Reserves (ACR)
Additional reserves deemed necessary by management

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

AGM
Annual General Meeting

AIM
A sub-market of the LSE

AIR
AIR Worldwide

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

Best Lancashire Assessment of Solvency over Time (BLAST)
The Group's (ex Cathedral) economic internal capital model

BMA
Bermuda Monetary Authority

Board of Directors
Unless otherwise stated refers to the LHL Board of Directors

Book Value per Share (BVS)
Calculated by dividing the value of the total shareholders' equity by the sum of all common voting shares outstanding

BSX
Bermuda Stock Exchange

Cathedral; Cathedral Group
Refers to CCL and all direct and indirect subsidiaries of CCL

CCHL
Cathedral Capital Holdings Limited

CCL
Cathedral Capital Limited

CCL 1998
Cathedral Capital (1998) Limited

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

CEO
Chief Executive Officer

CFO
Chief Financial Officer

Consolidated financial statements
Includes the independent auditors' report, consolidated primary statements, accounting policies, risk disclosures and related notes

CRO
Chief Risk Officer

CUO
Chief Underwriting Officer

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

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

EBT
Lancashire Holdings Employee Benefit Trust

ECA
Economic Capital Assessment

EIOPA
European Insurance and Occupational Pensions Authority

ENID
Events Not In Data

ERM
Enterprise Risk Management

EU
European Union

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

Expense ratio
Ratio, in per cent, of other operating expenses to net premiums earned

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

FAL
Funds at Lloyd's

FCA
Financial Conduct Authority

FRC
Financial Reporting Council

Gross premiums written
Amounts payable by the insured, excluding any taxes or duties levied on the premium, including any brokerage and commission deducted by intermediaries

The Group
LHL and its subsidiaries that are fully consolidated for Solvency II

IFRS
International Financial Reporting Standard(s)

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

IRRC
Investment Risk and Return Committee

KCML
Kinesis Capital Management Limited

KHL
Kinesis Holdings I Limited

KINESIS
The Group's third-party capital management division encompassing KCML, KCMMSL and the management of KHL and KRL

KRL (KINESIS RE)
Kinesis Reinsurance I Limited

LHL (The Company)
Lancashire Holdings Limited

LICL
Lancashire Insurance Company Limited

Lloyd's
The Society of Lloyd's

LOC
Letter of credit

Losses
Demand by an insured for indemnity under an insurance contract

LSE
London Stock Exchange

LUK
Lancashire Insurance Company (UK) Limited

MBRT
Multi-beneficiary reinsurance trust

MCR
Minimum Capital Requirement

Names
An individual member underwriting with unlimited liability. Since 6 March 2003 no person has been admitted as a new member to underwrite on an unlimited basis

NAV
Net asset value

NED
Non-executive Director

Net acquisition cost ratio
Ratio, in per cent, of net acquisition expenses to net premiums earned

Net loss ratio
Ratio, in per cent, of net insurance losses to net premiums earned

ORSA
Own Risk and Solvency Assessment

OTC
Over the counter

PML
Probable maximum loss

PRA
Prudential Regulation Authority

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

QST
Quota Share Treaty

RCC
Risk and Compliance Committee

RDS
Realistic Disaster Scenarios

Retrocession
The reinsurance of a reinsurance account

Return on Equity (ROE)
The IRR of the change in FCBVS in the period plus accrued dividends

RFF
Ring Fenced Fund

RMS
Risk Management Solutions

RRC
Risk and Return Committee

RSC
Reinsurance Security Committee

RSS
Restricted share scheme

SCR
Solvency Capital Requirement

SF SCR
Standard Formula Solvency Capital Requirement

SM&CR
Senior Managers and Certification Regime

SMF
Senior Manager Function

Standard & Poor's (S&P)
Standard & Poor's is a worldwide insurance rating and information agency whose ratings are recognised as an ideal benchmark for assessing the financial strength of insurance related organisations

Syndicate 2010
Lloyd's Syndicate 2010, managed by CUL. The Group provides capital to support 57.8 per cent of the stamp

Syndicate 3010
Lloyd's Syndicate 3010, managed by CUL. The Group provides capital to support 100.0 per cent of the stamp

The Syndicates
Syndicate 2010 and 3010

Total Shareholder Return (TSR)
The IRR of the increase/ (decrease) in share price in the period, measured in U.S. dollars, adjusted for dividends

TPS
Technical provisions

UK
United Kingdom

UMCC
Underwriting and Marketing Conference Call

uSCR
'To Ultimate SCR': Solvency Capital Requirement as used for Lloyd's Member Capital Setting which reflects the 1:200 balance sheet deterioration until all liabilities have been paid or settled. Compares to the Solvency II SCR which reflects the 1:200 movement over one-year only.

Unearned premiums
The portion of premium income that is attributable to periods after the balance sheet date that is deferred and amortised to future accounting periods

Value at risk (VAR)
A measure of the risk of loss of a specific portfolio of financial assets