Q3 2011 Earnings Call

Company Participants

- Alex Maloney, COO, Group Chief Underwriting Officer
- Elaine Whelan, CFO
- Neil McConachie, President
- Richard Brindle, CEO
- Unidentified Speaker, Company Representative

Other Participants

- Ben Cohen, Analyst
- Christopher Hitchings, Analyst
- Jonny Urwin, Analyst
- Nick Johnson, Analyst
- Thomas Fossard, Analyst
- Tom Dorner, Analyst
- Unidentified Participant, Analyst

Presentation

Operator

Welcome to the Lancashire Holdings Limited's Q3 results conference call. (Operator Instructions) I would now like to turn the call over to your host, the Group Chief Executive Officer, Richard Brindle. Sir, you may begin. Thank you.

Richard Brindle {BIO 1983776 <GO>}

Thank you, very much and thanks everybody for dialing in. I would like to also introduce the other speakers who in order are, Alex Maloney, who you know is our Group COO; Elaine Whelan, our Group CFO; and Neil McConachie, our Group President.

This has been a very long year and we're still only in November. The rather small to medium cat losses, a large and costly earthquake in Japan. And the largest energy risk loss since Piper Alpha, along with a dismal and volatile investment climate have combined to make 2011 an extraordinarily difficult year to make money in. And against this backdrop, we are pleased to be in positive ROE territory at the end of Q3 to the tune of just over 10%.

In a rational world with most companies showing triple digit combined ratios, the market would now be hardening across the board. There are positive niches, especially retro, which we're well-positioned to take advantage of with our accordion sidecar.

Other opportunities present themselves in the property cat arena, Japan, Australasia with caution. And Canada amongst them. But the primary insurance lines remain piquant, with crazily enough, rate reductions continuing in some cases.

The overall picture for our portfolio with its current roughly 40% reinsurance rating is positive. But in our view, one-third[ph] of the decent sized cat loss is required before the unsustainability of the current rating environment becomes inescapable.

Until then, we must remain patient moving into the pockets of opportunity. But otherwise not markedly increasing our underwriting activities, whilst at the same time, remaining cautious on investments in this volatile and uncertain world. And that is what we will do. I'm now going to hand over to Alex.

Alex Maloney {BIO 16314494 <GO>}

Thank you, Richard. The First Quarter of 2011 we continue seeing severe cat losses around the globe. Lancashire is pleased to report that our underwriting approach has again seen us avoid significant loss from Hurricane Irene, the Danish floods or other events that have impacted the market.

Our combined ratio for the quarter of 43.5% is a very satisfactory result in this context. Our overall RPI saw a solid increase to 112% compared to 106% in the Second Quarter. Of the 18 individual sub-parties reporting an RPI in this quarter, 14 were 100% or higher.

Looking at the individual classes for the quarter, property reinsurance continues to be the most interesting arena. And Lancashire again demonstrated the benefits of its nimble strategy when coupled with the focus on underwriting basics.

In the property cat and retro markets, Lancashire was able to supply urgently needed capacity both to long-standing and new clients at strong pricing levels. Accordion, the reinsurance sidecar, has been well received and deployed capacity to new and existing clients. Premiums for property reinsurance increased from $21 million to $35 million year-on-year for the Third Quarter, which bodes well for 2012.

A substantial element of this was the renewals of the Japanese contracts extended from April, as well as new business for both New Zealand and Australia. Lancashire did restrict capacity for some renewals, particularly those that were heavily affected by RMS 11 model change, which did not pay the royalties[ph] appropriate for the increased capital charges.

For direct property we're pleased that US cat exposed business has in general been paying increases, whereas in the Third Quarter 2010 decreases were still being given. Lancashire continues to be very selective especially for non-US business and premium levels have fallen as inadequate real[ph] terms are not supported.

In energy an RPI of 108%, down from 115% in the prior quarter, was probably a fair reflection of the modest reduction in the price[ph] of improvement of terms and conditions. Premiums were overall steady, with less premiums written in the Gulf of Mexico energy costs due to multiyear contracts written in the Third Quarter of 2010, offset by new business and rate increases in the worldwide Offshore segment.

We continue to watch developments in the energy liability arena. But as yet do not judge that opportunity as compelling. Much depends on the ability of the Lloyd's franchise board to enforce separation of liability coaches[ph] from packages.

For our specialist aviation and marine lines the Third Quarter is not the significant one. And allows for changes in renewal dates. Both premiums and RPIs were generally flat.

We continue to maintain a very narrowly defined appetite for both classes. And the only development is some sign of an increase in (inaudible) risk[ph] activity. However, in the current volatile economic climate, it is too early to call this significant.

In terrorism and political risk, our sovereign risk account, we have similarly limited appetite. This is reflected in a reduction in premiums, although our RPI was at 99% for the second -- for the Third Quarter of writing[ph] to terrorism. We regard risk selection as keenly positive[ph]. And our underwriting tool[ph] is an excellent tool to bring diverse knowledge forward[ph] to bear on individual risk assessment.

Looking into the crystal ball for 2012, we see much to be encouraged about. But the picture is far from clear. The model changes from RMS for both Europe and US wind are still meeting resistance. But there is growing realization that they have to be dealt with rather than denied.

There are anomalies in results which are rightly being questioned. It's interesting to remember how quickly and unquestionably the changes to the RMS US earthquake model were accepted when they reduced the industry loss. Even with model blend-in the final result will be an increase to PML and capital charges, which should result in more reinsurance demand. Whether this is fully realized in 2012 or drags to 2013 is open to debate. But we have been very encouraged by the level of interest in that accordion product in recent weeks.

Retrocession is one area of the market where capacity (inaudible) providers[ph] is constrained and demand is up. For energy, the treaty renewal for 1 January will be a significant outlook on the market for 2012. If retentions are increased following substantial losses in consecutive years it may be possible to push through sensible improvements on the front end. Absent this, concession amongst direct writers will probably weaken the market further until managements get involved and call a halt. For other parties we will maintain our risk selection rigor and do not expect any substantial changes.

The understanding that our investment contribution to results is probably set for a long period of stagnation will apply pressure to improve combined ratios. Pricing, terms and conditions should therefore strengthen; however, industry capital will be certainly in excess of demand and will probably continue to restrain increases for the present.

But with annual cat losses approaching $100 billion many insurance and reinsurers having shrunk book value in the year to date and the industry valuation at historic lows, the market correction seems necessary. As Accordion has demonstrated, Lancashire is able to discern opportunities early, bring capital to bear on them and provide solutions to brokers and clients in a decisive and timely manner.

Lastly, I would like to thank our colleagues in our Dubai office for the professionalism and understanding they have shown with our decision to close our regional marketing office. This has been down to the economic downturn in Dubai and Lancashire strategically aligning its assets to generate the best possible return for shareholders. We will continue to travel to the region from London and I, along with Paul Gregory, have spoken to clients directly. We will not lose any business from this move. I will now hand over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Cheers, Alex. Hi everyone. Our results are laid out on our website as usual. The quarter has been quiet as far as major hurricanes in the US go, except in Hurricane Irene. There have been plenty of other losses impacting the industry, along with continuing creep[ph] on prior-quarter (inaudible) reserves.

With minimal impact to Lancashire from those, we've had an excellent underwriting performance, producing an underwriting profit of $101.8 million on a combined ratio of 43.5%. Unfortunately, we were quite negatively impacted by invested performance. The loss for the quarter is 0.6% with about 0.4% of that driven by foreign exchange losses.

Despite that, we still produced a pretty strong return for the quarter of 3.6%. And have now compounded fully converted book value per share since inception annualized at 19.8%.

Taking investments first then, given our losses there, in early 2011 we deemed inflation and interest rate risk as the biggest risk to our portfolio. As a result, we've structured our portfolio to mitigate these risks and allocated a very small portion of our portfolio to execute investments to hedge against downsize risk in our fixed income portfolio. That dynamic was working pretty well earlier in the year, along with our emerging market debt portfolio, in diversifying our portfolio and proving to be an effective hedge.

However in Q3 with the US debt still in debate, the European debt crisis and fears of contagion caused increased concerns of a global recession, the risk[ph] (inaudible) dominated. Risk assets[ph] were analyzed[ph] very quickly and the volatility increased rapidly despite fundamentals. Our equity hedge no longer works as correlations tend to bid down in periods of stress.

The Fed also announced its intention to keep rates excessively low due to recent (inaudible) 2013 (inaudible), eliminating near-term inflation and interest rate risks. Inflation and interest rate risk are therefore less of a concern to us right now. The ongoing volatility is however. And as we continue to be committed to capital preservation first and foremost, we chose to limit any further downsize and liquidated our equity portfolio. It would appear we stuck our toe back in those waters too soon.

Ignoring foreign exchange, we lost $4.8 million in the quarter, of which $7.9 million is to be like losses on our equity portfolio. So we're not getting that back. This was tempered by $5.5 million of realized gains from our TIPS[ph] portfolio, which we liquidated given our inflation outlook.

We also took some losses on our emerging market debt portfolio, although these were largely currency related. Of our $9.7 million foreign exchange loss for the quarter, $7.9 million of that related to our investments, with most of that unrealized. With the strength in the emerging market exchange rate post quarter end we have made back about half of that.

We continue to believe emerging market fundamentals remain strong. And continue to allocate a portion of our portfolio to them, albeit we've trimmed that back a little particularly as regards to currency exposures.

Our focus on investments going forward will be back to basics. We want to limit downside risk, accepting we will lose out on the uptick when the market finally recovers. With the global uncertainty just now as we will keep duration short and focus on lower CapEx but higher allocations to cash.

(inaudible) investments there are a few other things I would like to highlight for the quarter. Firstly, premiums are just under 6% higher than the Third Quarter of last year and over 12% down on the prior year.

To remind you, in 2010 with lots of[ph] property cat and energy loss[ph] (inaudible) amounting to around $75 million. The (inaudible) of those[ph] was in the first half of the year. So you will not seen that in the quarter-on-quarter comparison. So building on my comments from last quarter, although this quarter was pretty much in line with Q3 2010, with the favor[ph] of moving in individual lines.

Within property cat reinsurance, as Alex said, the Japanese April 1[ph] extension came through. We saw significant rate increases there and we also saw some more opportunistic (inaudible) business. That was offset by the nonrenewal of a major Florida account and also the timing of some multiyear deals from 2010.

In property retro, I mentioned last quarter we (inaudible) a handful of deals in June and July (inaudible). So some of that is reflected this quarter and (inaudible) Accordion vehicle.

We haven't put any more retro on our books at October 1. As Alex has alluded to, we see the best opportunities at January 1. And we utilized Accordion (inaudible) two-thirds of the vehicle's capacity utilized at that point. Otherwise, this opportunity continues to be cautious of political risk (inaudible).

The energy group (inaudible) by line are largely due to the timing of renewals on a few deals written on a multiyear basis this year. For the year ahead, while certain lines present clear opportunities, this isn't across the board. We're anticipating a large expansion in property retro and cat, offset typically[ph] by around $40 million of multiyear deals within energy, which wouldn't be up for renewal yet.

Overall our growth strategy should be up in 2011, although our RPIs, which only reflect like-for-like renewals, may not really reflect that given the amount of new business we're expecting in the retro arena.

We also have an 85% (inaudible) Accordion from our retro book. So that will impact net written. Otherwise our reinsurance program is expected to be broadly in line with the expiring[ph] program, although it's obviously early days on that.

On reserves, as I mentioned earlier, they will have no real impact for Q3 major losses. And reported risk losses were also low. We have had some negligible increases in our Japanese and (inaudible) reserves, both up a few million, still well within expectations.

While we don't typically discuss individual accounts, we're aware of market rumors regarding a certain mutual company. We're waiting for the next formal update from our cedent. But we have currently reserved[ph] a little above their last reported numbers. So we have some margin there. It is clear that (inaudible) lost their faith[ph]. But they're working diligently on loss expectations. And we expect to hear from them very soon.

We have additional unreserved exposure[ph] of the top layer of their program. So our current reserves reflect our best estimate based on discussions with our clients and their broker. We will update those estimates as we receive further information.

We've maintained the precautionary reserve[ph] on the Gryphon loss in relation to our energy IOW[ph]. These remain untriggered and we don't expect much to change there until we are into fairer weather in 2012 and a reassessment of the losses made.

Total prior accident year reserve releases[ph] were $21.1 million, with no real specific drivers. This was pretty much across line, with most of the relief[ph] coming from the 2010 accident year.

Our equity-based compensation charge looks a little low this quarter. The standard quarterly charge is in there. But this is almost entirely offset by an adjustment to the estimated fair value of parts of our RSS plan. We engaged (inaudible) consultants to review our program fair value estimation. And this led to small adjustments to each year of RSS awards. Not a material amount particularly for any given year. But we estimate this expected charge (inaudible) follow[ph] this quarter. All of this has a[ph] low impact on

ROE. But you could probably expect a slightly reduced equity-based comp charge going forward.

Lastly on the capital side, as you know, we're obsessed with our cash flow levels and review them constantly. There are a lot of factors that we consider in determining the right level. Our underwriting outlook is positive for next year. But not spectacular. We are also cognizant of the volatility in the investment markets and the state of the capital markets. So all that together, plus a few other bits and pieces. And we think we have more than enough cash flow to take advantage of the opportunities ahead of us, maintaining an appropriate level of hedges for any improvements on our current reviews.

We are therefore returning capital to our shareholders in the region of $150 million, where[ph] we have a special dividend of $0.80 per share. As we move into 2012 and we see how the markets shape up, we will, as ever, the effect of capital requirements. And with that, I will now hand over to Neil.

Neil McConachie {BIO 7540962 <GO>}

Thank you. Hello everyone. Richard briefly mentioned this on the last earnings call. But I just wanted to let people know if you have not already heard that after 14 years in Bermuda the McConachie family is scheduled to move back to the UK in Easter of next year. I will have the joy of commuting to Lancashire's office and British rail in the rain rather than a nice steady ride in the sun across Hamilton Harbour.

I have bought a lot of shares in Lancashire over the years. And the value of the shares are now sitting well above cost. One of the nice things about being a resident in Bermuda is that you can realize capital gains without paying capital gains tax, where the UK residents are not so fortunate. So for technical reasons you are going to see me selling shares and warrants to realize these capital gains between now and Easter.

To state the obvious this has nothing to do with any lack of confidence in Lancashire. And I will rebuild my holdings back up after an appropriate length of time. And by doing so will reset the cost base at a higher level. I just wanted to mention it now. So it didn't spook anyone when you see press releases announcing these sales.

We will now hand back to the operator. And happy to take your questions. Thank you.

Questions And Answers

Operator

(Operator Instructions) Jonny Urwin, Jefferies

Q - Jonny Urwin {BIO 17445508 <GO>}

Yes, hello. Thank you. I was just wondering if you could give us some color on the Thailand floods? I've been hearing a lot of the companies affected are Japanese (technical difficulty) to buy extensive reinsurance and that this could have come through the London market. I was just wondering if you could elaborate some?

A - Richard Brindle {BIO 1983776 <GO>}

Yes, sure, Jonny. I have got that one. You're right. I'm hearing numbers today which I'm sure you've heard, which is around a bend field[ph] estimate of $5 billion insured. And that is mainly going to be Japanese companies, technology companies, hard drive manufactures, that sort of thing.

I don't think it's going to be a problem for us because our DNS[ph] account (inaudible) very high up with the exception of sort of at least 12 months DR[ph] on the big locations and the big physical damage loss as well.

I think where it is going to come from is two things. First, we see people writing[ph] treaties, pro rata treaties that are often referred to as JIA, Japanese Interest Abroad treaties, which you are right are widely based in the London market. But also a lot of our peers open Singapore offices, I think you know our view on Singapore offices as a general proposition. And I would imagine they're getting a fair share there because it is regional business. So I can't give you a huge amount more than that. But I think we're going to see some nasty losses emerging.

Q - Jonny Urwin {BIO 17445508 <GO>}

Okay. Great. Thanks a lot.

Operator

Tom Dorner, Citigroup.

Q - Tom Dorner {BIO 15847486 <GO>}

Hi there. I was going to ask, are you seeing new vehicles being set up -- new capital potentially entering the industry? I was just wondering since retro seems to be an attractive class of business are you seeing any change -- any new participants that could potentially threaten Accordion's ability to take advantage of better pricing?

A - Richard Brindle {BIO 1983776 <GO>}

Not a lot. Tom, this is Richard again. As you may know (inaudible) I think they have reloaded. But they were in the market anyway. Alex, free to jump in. I'm struggling to think of new retro capacity that we've seen coming from (inaudible).

A - Alex Maloney {BIO 16314494 <GO>}

No, I don't think so. I mean, we haven't seen anything as yet. And even so, I still think it is pretty difficult to convince people to part with their money. So I don't think it will be a problem for us to deploy that capital in Accordion at this moment in time.

Q - Tom Dorner {BIO 15847486 <GO>}

Can I also just ask on Accordion, when you write business through it, does that -- is that subject to the same sort of daily underwriting call that you go through for the rest of your business. So it is subject to the same sort of risk controls?

A - Alex Maloney {BIO 16314494 <GO>}

Absolutely. Because actually if you think about it, Tom, if you add up both our investments in Accordion and our retention agreed with the investors in Accordion, we retain something like 30% of every which[ph] we write -- a bit more actually. So, yes, it is going on our balance sheet too. And it goes through exactly the same rigorous process as any other risk.

Q - Tom Dorner {BIO 15847486 <GO>}

Thanks.

A - Alex Maloney {BIO 16314494 <GO>}

No problem.

Operator

Christopher Hitchings, KBW.

Q - Christopher Hitchings {BIO 2034501 <GO>}

A couple of things, just the 6 million released in Chile, that is included in your reserve releases. So does that mean there is a normal of 15?

Secondly, in terms of Accordion, assuming the associate will be aware[ph] of the profits of your ownership of Accordion come through. But are there any other contributions? I mean, clearly there will be a gross premium, there will be a ceding out. And then ROEs are part of the risk. Are there any commissions that will be coming into the P&L, other than the associates' compensation?

A - Richard Brindle {BIO 1983776 <GO>}

I think those are probably both for Elaine.

A - Elaine Whelan {BIO 17002364 <GO>}

I think that the 6 million released in Chile is picked up wrong[ph]. If you read the press release it is referring to Q2 2010 as a comparative information. So 21 million released (inaudible) in this quarter. And there is nothing really that big in there. It is centered across lines and it may be a little bit more than we would typically expect. But there is not really anything in particular driving that.

Q - Christopher Hitchings {BIO 2034501 <GO>}

(inaudible) in the press release. I am sorry. I apologize for that.

A - Elaine Whelan {BIO 17002364 <GO>}

No worries, you are not alone there. So I am glad to clarify that. And on the associates, yes, we get the profits in line there. And other contributions we get an overwrite commission on Accordion of 4%[ph]. And you will see that coming through the commissions line and the acquisition costs. The other thing we get is a profit commission of 13.5%. But we won't get that for a little while yet because it is contingent on performance.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Right. And so you will book that a year in arrears, will you?

A - Elaine Whelan {BIO 17002364 <GO>}

Yes.

Q - Christopher Hitchings {BIO 2034501 <GO>}

So that will come through -- and again, through the acquisition cost?

A - Elaine Whelan {BIO 17002364 <GO>}

Yes, you're right there.

Q - Christopher Hitchings {BIO 2034501 <GO>}

So you will see (inaudible). Thanks. Good afternoon[ph].

A - Elaine Whelan {BIO 17002364 <GO>}

Sorry?

Operator

Frank Haywood[ph], Frank Haywood Associates[ph].

Q - Unidentified Participant

Hello there. Congratulations again on another good quarter with the outstanding underwriting results. Also congratulations for the relatively good investment results considering the turmoil in the markets.

A - Richard Brindle {BIO 1983776 <GO>}

Thank you.

Q - Unidentified Participant

Special congratulations to Elaine for doing a great job in keeping the investment portfolio low risk, keeping the duration low and not being tempted to reach for yield in a low return environment. So just no questions, just congratulations to all.

A - Richard Brindle {BIO 1983776 <GO>}

Thank you, Frank.

Operator

Ben Cohen, Collins Stewart.

Q - Ben Cohen {BIO 1541726 <GO>}

Hello. Good morning. Could I just ask on the energy account, I was just wondering if you could say a little bit more about the level of competition? I guess, from previous commentary it seems that you've been a bit disappointed that the market hasn't moved more for Gryphon. But maybe you could say more as to what you think might happen through the renewals? And then what your apatite is at current prices into 2012 given the other opportunities maybe on the property cat side?

A - Richard Brindle {BIO 1983776 <GO>}

(inaudible), Alex?

A - Alex Maloney {BIO 16314494 <GO>}

Yes, sure. I think it is fair to say we're disappointed. We are still seeing rate increases. But they have slowed down from the Second Quarter. It appears that some people have come back from their holidays and forgot about Gryphon and some of[ph] the other things that have happened in the energy world. So I think we are slightly disappointed.

What I would say, though, is we have a good underlying portfolio if you look at our loss ratios -- any way it is still a good portfolio and we are still happy with it. It just means that we can't sort of go out there and write material amounts of new business.

Obviously 1 January is renewal season for energy direct writers when they're buying their reinsurance programs. And the reinsurance market has taken a further pain[ph] this year. So you would think or you would hope that those reinsurers will put their prices up and impose some stricter terms and conditions.

The fact of the matter is it is only direct energy markets. (technical difficulty). So I think for us it means stable portfolio. There will always be organic opportunities for growth on our book because we have a large book of business and we're a big player in that market. It just means that we are not going to go out and write material amounts of new business at this moment in time.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Could I ask as a follow-up, could you just remind us where we are in terms of drilling in the offshore in the US. And when and how much that market could open up?

A - Alex Maloney {BIO 16314494 <GO>}

Yes, that's a good question. I mean, obviously post Macondo, the government (inaudible), that slowly reopening. And we are seeing a few opportunities where operators are starting to drill wells again in the Gulf of Mexico. I think we saw one probably a week ago where that client was buying unprecedented amounts of new limit[ph] first couple of wells in the Gulf.

So, yes, there will be opportunities there. It will still be slow -- permitting is still slow in the Gulf of Mexico. And some clients won't buy huge amounts of limit. But there will be opportunities for us then. We like that business. We think the risks we have got better post Macondo. It's just hard to say at this moment on how quickly we are going to see those opportunities.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay, thanks very much.

Operator

Thomas Fossard, HSBC.

Q - Thomas Fossard {BIO 1941215 <GO>}

Three questions from my side. The first question is on the -- in Q3 obviously you had a sense of the (inaudible) US Hurricane Irene and the Copenhagen storms as well. Could you remind us if it was because you thought that specifically this (inaudible) in terms of recent exposure were not adequately[ph] priced or because, in fact, the magnitude of the losses were not high enough to attach your (inaudible)?

The second question is (inaudible) to your appetite for a net cat business next year. Looking at your current business, you are writing 32%[ph] of your book -- or 52% of your book is (inaudible) cat exposed. How much could it be next year, if obviously, opportunities you are currently seeing in the cat market, especially in the US is taking place next year?

And the (inaudible) next question would be, are there any material impact in the Q3 results out here very, very short-term (inaudible) covers[ph] you sold on the back of the New Zealand quake, which happily[ph] now completely you are finished (inaudible)? Does that create some significant positive results in the Q3 P&L? Thanks.

A - Richard Brindle {BIO 1983776 <GO>}

Okay. Let me start with the last of those questions. The back halves[ph] we basically, I think, in 2010 we wrote about $1 million of Australasian cat premium. And this year we wrote $16 million, which is not an earth-shattering number. But it is 16 times what we wrote the year before. And all of that half[ph] has already run off.

So I think that will give you a flavor of how sort of opportunistic and short-term the opportunity was. And how beneficial it has been to us this year. And the fact that half of it was already started is obviously a rather nice[ph] position to be in.

I will leave it to Alex to take the second question about net cat (inaudible) here. But I will talk about a little bit maybe he and the others will also talk about this. Why did we miss these cat[ph] (inaudible) losses. Well, we mostly (inaudible) because there will be bad days at the office for Lancashire. But there is a good logical reason why we weren't involved in things like the Copenhagen (inaudible) and the Midwest storms and Hurricane Irene.

You know, we're of the view that we are not here to pay attritional catastrophe losses, which aren't going to have any sort of effect on pricing, whether in the region that the particular cat[ph] or more generally. And so we just try and avoid those sort of covers.

If you look -- you know, a lot of companies are reporting and talking about Midwest aggregates. Well, if anybody has been in the business for a while, you know the very concept of writing an aggregate catastrophe cover to me is pretty limited in the first place. But that is also attaching far too low down[ph]. You know it rains for a couple of days in Copenhagen, you shouldn't be picking up losses if you are a proper cat business (inaudible). Call me old-fashioned.

Even the size (inaudible) you would like to think that if it a (inaudible), you really shouldn't be getting tagged too match. We always have in mind when we construct our catastrophe exposures to think about, well, how much capital do we want to expose to a certain severity of events? And one of the key end[ph] questions we ask ourselves is -- were that event to occur, we look at -- and Neil you can talk about blast[ph] in a minute -- we look at the market, the level of excess capital. And then we make a judgment about how likely we think that an event of that -- if an event of that severity were to happen to us, what would that do to the overall market? And if we don't think it would make a difference then we try not to take on major exposures. Perhaps you could enlarge on that a bit, Neil?

A - Neil McConachie {BIO 7540962 <GO>}

Yes, we meet every two weeks. There's a whole pile of people across departments, we meet every two weeks and we look at this kind of thing. And you summarized that reasonably well already. But we don't in a sense really mind losing a bit of money if everyone else is losing a lot of money and it is a great market opportunity afterwards, you will be able to get your money back fairly quickly.

In that scenario, you should be able to raise money more easily because it is going to be a great hard market. But what we do mind is losing a chunk of money that it doesn't make any difference. And so we're sort of constantly tweaking our portfolio with that loss in mind.

A - Richard Brindle {BIO 1983776 <GO>}

And then the middle question, Alex, is about what sort of cat, non-cat balance we might have in 2012?

A - Alex Maloney {BIO 16314494 <GO>}

Yes, obviously as we have said, probably the reinsurance lines don't[ph] have much pricing next year and there could be some good opportunity. I think that means we could write up to 40% net cat next year. But again, subject to opportunities, what happens in the market. We've got no -- there is no set split here. I think as usual we will just look at the opportunities that are available and then go from there.

A - Richard Brindle {BIO 1983776 <GO>}

I think what we'd just say is, looking at the size of the special dividend, we could have done more than we did. But there's more uncertainty now at this time of year than there was in the past years at this time. And so we just wanted to hold back a little bit more capital than we would normally hold back, because of exactly what Alex has just said. And we will see what happens in Q1 next year.

I think that's a really good point. The way we think about things, if you look at people's combined ratios, you look at everything that has happened this year, hopefully if there is another event or a catalyst for the market to change, hopefully it could change quite quickly. And as Neil said, we want to be there and have the ability to trigger[ph] that market immediately.

Q - Thomas Fossard {BIO 1941215 <GO>}

Another question for Elaine, a very small one. I saw the financing costs were picking up in Q3 to $5.6 million or $5.9 million (inaudible) trends in pattern or maybe a little blip?

A - Richard Brindle {BIO 1983776 <GO>}

Elaine.

A - Elaine Whelan {BIO 17002364 <GO>}

Yes, that's all just[ph] the mark-to-market on the swap you are seeing there, the change in underlying.

Q - Thomas Fossard {BIO 1941215 <GO>}

Okay, thank you.

Operator

Nick Johnson, Numis Securities.

Q - Nick Johnson {BIO 1774629 <GO>}

Hi all. A question on the terrorism account. I noticed that the quarter-by-quarter, RPI is chips[ph] down. I just wondered if you could characterize how you see price adequacy for that segment at the moment? And how far are we away from the point perhaps where you need to reduce your exposure to the pure terrorism class?

A - Richard Brindle {BIO 1983776 <GO>}

I'll take that one, Nick. We like the business a lot. Our loss ratio has been pretty much nothing since inception. And we feel that because we have a very strong political risk team we're in a very good position to write terror.

What disappoints us on a daily basis, to be frank with you, is that we are up against pretty junior underwriters who are terrorism specialists (inaudible) specialists. And we just don't think they read The Economist and inform themselves about world affairs. And we find some of their decision-making pretty baffling.

We saw a risk[ph] in Jordan the other day which was (inaudible) on a primary basis. And you think, well, are these people aware of the Arab Spring? Are they looking what is happening next door in Syria? Because we have to work in the real world, right. We continue to refine our accounts. We continue to retreat from occupancies which we might deem -- which are subject to open access or might be vulnerable to some sort of attack. We're looking very closely at the Arab Spring, how that's playing out. We've taken down exposures in places like Yemen.

We do still like the business. And the good thing is with our big line[ph] size we are able to often move away from the primaries where we think there is often multiple locations, a lot of coverage in there like CBI[ph], which we hate.

Like if I have[ph] open access to this sort of thing. I am just paying six floods[ph] of excess layers where we're really only focusing on (inaudible) locations. So you may see some drop in the terrorism income next year. But we have excellent distribution. We have a big team of underwriters, which you need for that line of business. They work very hard on both of their brokers and their client relationships.

And we're managing to keep that income up. But I think you could characterize the account as one that is shifting more towards excess layers with more and more carriers[ph] and multi-country schedules because obviously (inaudible) hazardous countries in there. And we're being very cautious.

Q - Nick Johnson {BIO 1774629 <GO>}

Very helpful, thanks.

Operator

Christopher Hitchings, KBW.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Yes, I'm terribly sorry for coming back. But I'm just thinking through, if you're not going to book the profit commission on Accordion until 2013, say, for the 2012 results, surely you won't be booking the profits from Accordion. So you'll need to match the accounting treatment of both. Is that reasonable, or will you try and put an estimate into the profit commissions? I'm sorry, it's a tedious accounting point.

The more salient[ph] point is I'm slightly surprised you are so disappointed that 3Q-on-3Q energy rates are less than 2Q-on-2Q. I mean if I recall from your conference calls, energy rates sunk down in the Second Quarter last year, rose sharply in the Third Quarter. So it stands to reason that Third Quarter is going to be less of a percentage increase than the second, or am I missing something?

A - Richard Brindle {BIO 1983776 <GO>}

Okay, thanks Chris. So Elaine and Alex.

A - Elaine Whelan {BIO 17002364 <GO>}

Sure. We are allowed to take our portion of the profits from the vehicle as we earn them. So we will be doing an equity pickup as we move along and as the vehicle makes profit.

The profit commission, we have to wait until the year that the rates have[ph] expired. And as soon as that runs off of what profit it makes[ph] before we can pay[ph] that commission. But because it's contingent, we can't take that until we actually have virtual[ph] certainty over that.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Thank you.

A - Richard Brindle {BIO 1983776 <GO>}

And, Chris, your point about energy, I think our frustration is that we felt following (inaudible) last year, following Gryphon this year, following four or five other large risk losses that don't even make the newspapers that momentum would build -- you know. Lots of people in the energy market are not making money. I am not saying that is everyone. But lots of people are not making money.

You are very close to this (inaudible) season where everyone is going to have to pay more for their reinsurance, including ourselves. So it just doesn't make any logical sense that underwriters are now weakening their views on rating, albeit you are getting rate rises year-on-year.

But if you look at the 100% sort of numbers for the class most people are going to be well into the 100%. So I don't think it's a time where underwriters should be sort of coming off the pedal or braking. I think they should be building momentum. But sadly that's our view and not everyone else's in the market.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Yes. But your comparison Third Quarter is a much stronger quarter than last year. Are you saying that rates for businesses renewing in the Third Quarter are renewing at less actual rate than in the Second Quarter (inaudible) would be the case[ph]?

A - Richard Brindle {BIO 1983776 <GO>}

No, we're saying the year-on-year rise is actually what it was[ph] in the Second Quarter. I think Alex is just saying you have two -- the two biggest losses since Piper Alpha in just over a year. We get to see the Lloyd's loss ratios, Chris, they're not pretty.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Don't worry, I'm aware of that. But I'm equally aware that I think according to probably no less business than Mr. R. Brindle. I think energy rates went up substantially in Third Quarter against Second Quarter last year.

A - Richard Brindle {BIO 1983776 <GO>}

Yes. That is. But we still see many who[ph] got more. (multiple speakers). We're doing fine, because we are very rigorous on our risk selection. Have you got the combined ratios to hand, Alex, for energy (inaudible)?

A - Alex Maloney {BIO 16314494 <GO>}

No, not yet.

A - Unidentified Speaker

I can tell you inception to date, since Lancashire has been in business our combined ratio for energy is 64% which is pretty good. (multiple speakers)

A - Richard Brindle {BIO 1983776 <GO>}

(inaudible) My point is, Chris, we don't want to name names, because we never do that. But there's lots and lots of people that we both compete with and sort of, if you like, cooperate with in Lloyd's energy underwriters who are -- you know, their biggest start was an 8 or a 9. And that is just the loss ratio year after year. And we are baffled as to why, despite a lot of very positive balanced[ph] statements from Lloyds, that they are allowed to continue getting away with that sort of underwriting. That's our point, that's all.

A - Alex Maloney {BIO 16314494 <GO>}

(inaudible) Remember that the Gulf of Mexico has gone clean[ph] this year. So people are making money. But equally the Gulf didn't have any event this year.

A - Richard Brindle {BIO 1983776 <GO>}

Okay, any more questions?

Operator

Tom Dorner, Citigroup.

Q - Tom Dorner {BIO 15847486 <GO>}

Hi. Just one quick question, it is on loss creep for Japan. I think you said that you have some sort of unreserved exposure at the top layer. I appreciate that this is kind of speculative. But can you give an indication of how much worse the insurance industry loss has to get before that layer starts being exposed or is it not as straightforward as that?

A - Richard Brindle {BIO 1983776 <GO>}

It is pretty complex but we are going to give you a very (inaudible) answer on that (inaudible).

A - Alex Maloney {BIO 16314494 <GO>}

Sure. Okay. I mean, obviously we get (inaudible) update the client[ph] everything that we have seen at the moment leads us to believe that we're incredibly comfortable with our technical reserve. We do have -- we are reserved more than the current ultimate loss estimate from the client. The claims run rate is actually slowing down now. So that gives us comfort as well. But we are reserved in excess of the current ultimate estimate from the client. And we do have some IBNR as well. So even if there is loss creep up to a certain point, we're more than happy with our current reserves.

We are going to Japan next week. We are going to sit down with our client and talk about their claims[ph] (inaudible) as well. Obviously, if there is any more creep (inaudible) that we need to address, we will. I think everyone needs to remember that we have only got 3% of the top layer. So if there is any more creep it will only affect Lancashire to the tune of 3% of the top layer.

A - Richard Brindle {BIO 1983776 <GO>}

Which is about $40 million. But we should have (inaudible) the impact would probably be less than that. In our extremely remote eventuality that somehow the program were totaled. It would have to go to $935 billion loss for that particular client. And the current estimates are nowhere near that.

The other thing that is going on of course is with each update we get (inaudible) it is the higher potential of the claims are settled. So we've seen them twice recently. And between those times the settlement rate went from 95% to 96%. They've only got 4% [ph] of claims outstanding now. So obviously your window is closing all the time, if you like.

So what we've done is we've taken the client's number which they're pretty adamant is the right number by the way. And then we have added a pretty decent buffer on top of that. And even if you were to go above that buffer we have quite a bit of (inaudible), which looks unlikely is going to be used up by anything else. So we're pretty happy with the number.

Q - Christopher Hitchings {BIO 2034501 <GO>}

That is very comprehensive. Thanks.

A - Richard Brindle {BIO 1983776 <GO>}

But just to be very clear, because we don't think we are hiding anything. We are 3% of the top layer. And by the way, the reason we are at 3% is the biggest line we write, is really what I was just saying to another caller a minute ago. When we look at what risk to take on and (inaudible) we try to think, well okay, if this layer gets[ph] (inaudible), it is going to be a really, really big event.

So I think you were also asking about market incent[ph]. I think most people would say the best estimate out of the market is obviously[ph] $40 billion. And so what I'm saying to you is logically for this particular client perhaps to step out by another 15% or whatever it will be, would be to take that north of $45 billion if you applied straightforward mathematics. And we think that's not going to happen.

But my point is, as you can understand, (inaudible) even to pay 1 yen on this top layer is already going to be a huge event. So that is why we write the big line at the top in the expectation that in the unfortunate event that we get tagged, we are at least going to have a market reaction which will then present us with underwriting opportunities.

Q - Christopher Hitchings {BIO 2034501 <GO>}

Excellent. Thanks very much.

Operator

(Operator Instructions) We have no further questions at this time.

A - Richard Brindle {BIO 1983776 <GO>}

Okay. Well, it just remains for me to thank everybody for dialing in.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.