Q1 2011 Earnings Call

Company Participants

- Alex Maloney, Group Chief Underwriting Officer
- Elaine Whelan, Group CFO
- Neil McConachie, Group President
- Richard Brindle, Group CEO

Presentation

Operator

Good day, ladies and gentlemen. and welcome to today's Lancashire Holdings Q1 2011 conference call. For your information, this call is being recorded.

I would now like to turn the call over to your host today, Mr. Richard Brindle. Please go ahead, sir.

Richard Brindle {BIO 1983776 <GO>}

Thank you very much. I'm joined by Alex Maloney, our Group's Chief Underwriting Officer; Neil McConachie, Group President; Elaine Whelan, Group Chief Financial Officer; Denise O'Donoghue, Group Treasurer; and Sylvain Perrier, Chief Actuarial Officer.

The notion of diversification has become something of a mantra to many in our industry. There is nothing wrong with the principle. Indeed, we actually pursue diversification within our own underwriting portfolio. But if it becomes an altar to be worshiped at with the need for adequate standalone pricing taking a back seat, then something is clearly wrong.

Writing Australasian property cat business would have made a lot of sense to us if we only considered the model. The diversified nature of this business would have meant that we would have required little if any additional capital to support it. However, the pricing with layers clearly exposed to events that could not remotely be characterized as one-in-100, let alone one-in-250 year events, paying under 1% online, simply made no sense. So we largely stayed out of the market with the exception of a couple of high attaching contracts. Although post-events we were, as you know, leading the market in pricing and writing backups at many multiples of the original pricing. This has allowed us largely to swerve the Australasian losses of the last two quarters.

Our Japan number is, we believe, reasonable and well within our one-in-100 quake PML. This has not always proved the case for other companies, and we believe this discrepancy is worthy of increased scrutiny from the analyst community.

Helping us in both parts of the world have been the determined efforts we have made to reduce our retro exposures. Retro, as we have often said, is a hard market product. The multiplier effect of prices, plus terms and conditions feeding through from the direct market by property Cat to retro, means the RPIs are either strongly positive or strongly negative.

Conversely, given recent events in the international arena and the effects of the RMS model change, we believe that the retro market will now become quite tight, leading potentially to some very attractive deals for us to write, and that will be a focus for us in Q2. We have seen the events of the last six months described as extraordinary in some courses. We are talking about $50 billion to $60 billion cumulatively, which I think suggests such language is somewhat hyperbolic.

That said, the losses, combined with the effect of Version 11, the impact of which has been put by brokers as akin to a $40 billion Cat loss, mean that in our view, most if not all of the excess capital in the sector will drain away over the next few months, and that alone will present both challenges and opportunities. We believe the latter will outweigh the former for us.

And now I'm going to pass over to Alex Maloney.

Alex Maloney {BIO 16314494 <GO>}

Thank you, Richard. Good afternoon, ladies and gentlemen. I will start with my view of our First Quarter results, and then I will highlight some of the key points which drove the result, and then I will move on to our underwriting outlook for the rest of 2011.

I seem to have become repetitive, but again, I can only describe the First Quarter of 2011 as a very active period for catastrophes that affect our business. Lancashire, like the rest of the insurance industry, has been challenged by the numerous loss events in the First Quarter -- the Christchurch earthquake, the tragic events in Japan, the Gryphon energy loss in the North Sea, and civil unrest in the Middle East. I'm happy to say that on all measures Lancashire's exposure to each event is well within management expectations and well within our probable maximum loss estimates for such events. Our net loss ratio of 97.4% for the First Quarter is testament to our disciplined underwriting and capital management approach. This has been a constant at Lancashire for five years now. We believe that recent events have confirmed our thinking that diversification for the sake of it or writing business that can appear capital-efficient according to the model alone can lead to very poor underwriting results.

The loss events of the First Quarter, coupled with the recent RMS model change, have produced a much more interesting underwriting environment. This changes daily, and we believe this will gain momentum for the rest of 2011 and into 2012.

We are now seeing an improvement in pricing across all our proxy and energy lines of business and the halting of reductions across terrorism and Marine lines. The main renewal date for the aviation terrorism class is not until November, so it is too early to predict at this time.

We believe the majority of excess capital in the industry has now been exhausted and the accumulation of events in the Fourth Quarter of 2010, the First Quarter of 2011, and the RMS model change all require more capital for exposures in peak zones. We are now pricing all our business using the new RMS model, and all business continues to be modeled in the real-time that we have always done. We see others in the marketplace traveling at different speeds, thus adding to more confusion in the market, which is changing daily.

Our reinsurance business by proxy, Cat and retro will become the most interesting with huge international loss experience, coupled with the RMS model change affecting US windstorm-exposed clients. We expect to see material rate increases for certain covers over the next 12 months as clients take stock of their own losses or capital requirements.

We also expect to see an increase in demand for coverage for in-loss amounts of this magnitude.

We have recently said that we believe retro is a more post-loss product for Lancashire; therefore, we are looking at the retro market with interest, and we will look to offer new retro products as opportunities materialize over the next 12 months.

(As one believing) underwriters of energy business, there will always be opportunities to organically grow this business line. But we do not see the current level of rate increases, basically 5%, as enough to write material amounts of new business. In the illogical market in which we operate, the Gryphon energy loss, which at $800 million is larger than Deepwater Horizon if you exclude the casualty exposure, has not affected the market to the same extent as post-Deepwater Horizon.

Again, the recent oil sands loss, which is estimated in excess of $1 billion, has not really changed the onshore energy market. Our portfolio of Gulf of Mexico Cat exposed deepwater assets are being renewed as expiring following a loss-free year in the Gulf of Mexico, and we are seeing an increase in demand from clients for more coverage.

Our outlook across our D&F property portfolio has changed considerably, and we now see rate increases, some material, on most renewals. This has been driven by international loss events and the RMS model change for windstorm-exposed clients. Our book will grow this year, but we believe the real opportunity will be in 2012 when the full implementation of the RMS model are felt.

Our terrorism portfolio and sovereign risk portfolio will remain stable with our exposure levels remaining the same until we see a hardening in rating or changes to terms and conditions. We remain disciplined on focusing our attention on the only writing business which we believe where coverage is identifiable, and we are getting paid well enough for the risk.

Our Marine portfolio will be relatively flat, but we will see growth in some large valued newbuildings, which will join the cruise ship fleet in the next 24 months.

To summarize our thoughts on underwriting opportunities, I would say our outlook has changed from stable to positive.

I will now hand over to Neil McConachie.

Neil McConachie {BIO 7540962 <GO>}

Thanks, Alex. Hello, everyone. So as Alex mentioned, the new version of the RMS US wind model is actually quite a big deal. It will have a direct and probably material impact on pricing for US hurricane risks and will probably have an indirect albeit somewhat lesser effect on pricing for catastrophe programs other than US wind. The impact will be caused by catastrophe writers having to carry more capital to support risks assumed than they did before, but also by technical pricing having to rise for some deals to make them make sense. For certain types of assets in certain regions, pricing will and already is having to rise dramatically in some cases.

In addition to the supply-side impact, RMS 11 will very likely create more demand for reinsurance protection, perhaps in particular for some companies who have seen excess capital rapidly diminish in the past six months or so.

In the past five years, we have made many adjustments to vendor models within our overarching BLAST capital model. The most notable changes occurred as a result of risk learning that we did after Hurricane Ike, which did result in our internal probable maximum loss numbers ending up materially higher than what comes out of the standard vendor box that you buy from the shop. Following the release of RMS Version 11 a couple of months ago, we have moved quickly to implement changes in our underwriting pricing already.

Comparisons between different commercial model outputs, including RMS and AIR and EQE, have always been embedded in our underwriting capital decisions, so nothing has really changed there. The full implementation of RMS 11 will likely increase our US wind PMLs a bit, but won't in any way prevent us taking full advantage of what look like increasing opportunities. We have got plenty of capital, so nothing has changed there either. We will be able to give more specific details next quarter.

Just one final thought from us. Some companies have commented that they believe the new RMS model is too conservative. We don't share that view. In fact, if history is anything to go by, the models have tended to be anything but conservative. The only thing you can be sure of with stochastic models is that they will be wrong. However, based on what we have seen so far, we reckon the new RMS version is likely to be less wrong than the old one.

I will now pass over to our esteemed Chief Financial Officer, Ms. Whelan.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Neil. Hi, everyone. Our results are laid out on our website as usual. Our First Quarter results were clearly impacted by the Tohuku earthquake and following tsunami. We have recorded a net loss of $75 million for Japan for the quarter. That is net of $2 million of reinstatement premiums.

Given the magnitude of the disaster, we are delighted with our results. The available exposure to other Tier 1 Cat events recorded$40 million stochastic model for Christchurch quake and nothing for Syria or Egypt or the wider unrest in the Middle East. There has also been no movement in our Chilean earthquake reserves this quarter.

The (Gryphon) loss, a standard risk loss, is contained within our reinsurance program retention of $25 million. Despite all the loss events, we have produced a return on equity of 0.4%. What I would like to note in our reserves is that we completed the reserve study we discussed last quarter on the February earnings call. We have engaged our external auditors to review our reserves to begin to incorporate our own experience into loss expectations and development patterns now that we have five years of history.

In general, development patterns for both us and the industry are faster than they used to be. Our loss (tax) going forward will, therefore, also be slightly lower, reflecting our performance being better than industry data. As a result of our study, we have a net release of prior accident year reserves of $36.9 million of our total release of $50.8 million for the quarter. Absent that reserve study, our loss ratio would have been 92.4%, resulting in a ROE for the quarter of negative 2.1%. Fairly good results all things considered.

A couple of other things to note for the quarter. Firstly, premiums are significantly behind the First Quarter of 2010. That is mostly coming from property with a little bit from our energy class. As we said last year, we wrote a number of multiyear deals within both these classes, about $75 million in total across the first and Second Quarters. $30 million of that was First Quarter property Cat business, and that is a very large driver of the reduction. So we will continue to see the benefit of those deals coming through our earnings this year and into 2012.

Also, as we said in the last call, we trimmed back our retro group a good deal at 1/1, so that is another driver of the reduction. Those reductions are offset a little bit by the (early) backouts we did and some reinstatement premium in relation to New Zealand and Japan.

Investment income was behind prior year, primarily due to lower yields, due to shorter durations, also lower asset base given our large special dividend at the tail end of 2010. We returned 26% for the quarter or 2.5% on an annualized basis. That is a pretty good result as far as we are concerned given the volatility in the quarter and the mixed economic news. We added a small amount of equities to our portfolio as we previously mentioned with a hedge to interest rate risk, and that has worked well so far.

On the capital front, as Alex mentioned, with the accumulation of loss events through Q4 and Q1, we have seen rate reductions stop and are seeing increases across our D&F

book, international property Cat and retro, and loss-affected accounts. Given our outlook, we expect to be able to utilize our capital base to take advantage of real price opportunities. As usual, we are unlikely to consider a special dividend until after the US wind season, and if we do pay one, it is likely to be significantly less than last year's due to the opportunities we currently see to deploy our capital.

In the past we have given money back when we have not had enough use for it. Right now we are pleased to have lots of good ideas to use our capital.

Also, at our current multiple, share repurchases don't make much sense as we can earn better returns for our shareholders through our underwriting. As ever, we will monitor underwriting opportunities and adjust our capital accordingly, whether that is a capital return or a capital raise.

And with that, I will hand back to the operator for questions.

Questions And Answers

Operator

(Operator Instructions)

A - Richard Brindle {BIO 1983776 <GO>}

We appear to have lost our operator.

A - Alex Maloney {BIO 16314494 <GO>}

That is no good.

Operator

Hello, this is the operator speaking. Hello? Hello, this is the operator speaking.

A - Richard Brindle {BIO 1983776 <GO>}

Operator, are you there?

Operator

Hello, this is the operator speaking.

A - Richard Brindle {BIO 1983776 <GO>}

All right. We may have to wrap this up.

Operator

Hello, this is the operator speaking.

A - Richard Brindle {BIO 1983776 <GO>}

Okay. It looks like we have lost the operator. Apologies. Nothing we can do about that. If there are any follow-up questions, then please contact Johnny, and we will take them off-line.

Thanks very much. We will talk to you next quarter.