Q3 2012 Earnings Call

Company Participants

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

Other Participants

- Ben Cohen, Analyst
- Chris Hitchings, Analyst
- Daval Garda, Analyst
- Olivia Brindle, Analyst
- William Hardcastle, Analyst

Presentation

Operator

Welcome to the Lancashire Holdings Limited Q3 results conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session. Please note that this conference is being recorded.

I will now turn the call over to your host, Richard Brindle. Sir, you may begin.

Richard Brindle {BIO 1983776 <GO>}

Thank you very much. Welcome, everybody. I'm joined by Alex Maloney, our Group Chief Underwriting Officer; Elaine Whelan, our Group Chief Financial Officer, and newly elected to the Board of Lancashire Holdings; and Denise O'Donoghue, who's our Head of Investments and Treasury.

Firstly, I would like to express the concern and sympathy of everybody at Lancashire for those in the USA and the Caribbean who have been affected by the devastation caused by Sandy.

There is much talk and focus on the non-traditional capital coming into our industry. The figure currently deployed is estimated at $30 billion. And what is striking is that only a small minority of that is invested behind established market players, such as Lancashire. The large majority is placed with managers with limited experience, outside of traditional catastrophe, few broker relationships, and a heavy reliance on vendor models.

As the sophistication of the investors increases, and I've been pleasantly surprised by the level of understanding some investors already have, we expect that not only will the amounts of non-traditional capital entering the industry increase, but that more and more of it will deploy behind established market practitioners, who understand their clients' needs, and fully respect the broker distribution network.

Against that backdrop, we have recently rolled over Accordion, our retro sidecar; and capitalized Saltire, a market-facing vehicle, offering a hybrid, elemental, and non-elemental aggregate product, which Alex can describe in more detail, in our Q&A.

We do not do these deals for the sake of the fees, welcome though they are. Indeed, it seems to us that certain companies are blinded by the fee income, and lose sight of the fact that the sponsor always has to have an investment, skin in the game, if you will; and that therefore the products created should always be attractive to the sellers of capacity in their own right.

Rather, we are seized by the fact that, all modesty apart, we have an excellent and long underwriting track record, and need to seek ways to monetize that expertise; and thereby, over time, to protect and enhance our multiple.

However, I should stress, we will never compromise the mother ship in any way. So you can expect us to develop this new fund management side of our business in a measured and incremental way.

I'll now hand over Alex.

Alex Maloney {BIO 16314494 <GO>}

Thank you, Richard. Obviously, Sandy is uppermost in everyone's minds, and our first concern must be for those whose lives have been directly impacted by it. As ever, the human cost is the worst part of these events, and our thoughts are with those affected.

We are aware of industry estimates from $5 billion to well in excess of $20 billion. And the range in itself tells you there is more than an unusual amount of uncertainty around this loss.

Discussions over wind and flood definitions, and the applicability of sub-limits in the crystallization of BI and CBI losses, will take some time to resolve. Just when power will be restored is an open question.

If we think back to the flooding loss in Thailand, early estimates were inaccurate. And we think much more information will be needed from policyholders and ceding companies before a meaningful estimate of quantum can be made.

For Lancashire, we have the benefit of ILW protection, which is triggered at a $20 billion event. So if the loss does develop to that point, we have a good tranche of reinsurance cover.

We can expect losses in our Property account, in particular, from the Direct and Fac portfolio, which we placed into runoff this year. We have not received any loss advice today, although we're in contact with brokers.

In terms of impact to the market, we would expect this to stabilize the property market for the North East, especially in the cat, XL and retro markets. The wider impact of the loss of this size is likely to be muted, given the strength of the industry's balance sheet.

In the Third Quarter of 2012, we are reporting on the main loss events, which were category one Hurricane Isaac, which is estimated to cause between $1 billion and $3 billion of insured losses; and the development of the multi-peril crop insurance losses in the US, which may, ironically, have been somewhat mitigated by the rains and the remnants of Isaac, brought to the South and the Mid-West.

Aside from the impact of Sandy, market sentiment has become more circumspect; and the confident predictions of continued rate strengthening, based on technical issues, the low investment yield, and slowly depleting reserves, are quietly being shelved.

Instead, both market practitioners and commentators are recognizing that the reserve cupboard is not yet bare, and capacity is at record levels. As such, there is no driver for broad-based rating increases except in loss affected areas. And we expect rates to be flat, at best, for most classes which we write. We do, however, note that rating levels in some of our key areas, such as offshore energy, property, cat and retro are close to their historic highs.

In the Energy line, premium rises are now in their third consecutive year, so it's not entirely surprising that they're running out of steam. However, a couple of factors are working in our favor.

First, the ending of the moratorium of drilling in the Gulf of Mexico and some improvements in the licensing process have seen a resurgence in projects. In the light of this some of the majors who don't buy insurance, such as BP, have been divesting assets to smaller companies that do.

Second, the scales of new projects around the world means that market capacity has been stretched to its limit which hands pricing power back to underwriters who are prepared to exercise it.

Thirdly, the Macondo experience is driving additional demand for high excess pollution layers where pricing can be attractive. Lancashire is marketing its appetite for this niche carefully to ensure we have a good spread of risks.

For Marine, it's disappointing that following the largest ever marine loss in Costa Concordia, circa $1 billion, the market over-capacity has meant that even flat renewal terms are seen a victory for underwriters. We are working actively to find new opportunities in our preferred niche classes of Marine such as war, mortgaged interest and additional perils.

In Terrorism and AV52, the story is that a lack of insured losses is encouraging new capacity both from existing market players and new entrants who compete on price. As both these coverages are often bought because they're mandated by regulation of mortgage holders, rather than because the insured perceives a real threat, clients are more inclined to buy the cheapest product than to think about continuity. As such, Lancashire has to compete on price and then the terror risk selection becomes even more important.

We have re-entered the satellite market for launch and orbit cover in the First Quarter of 2002 (sic) which we last wrote in 2008. We have a good track record with this class and we believe that can get good penetration through our existing relationships. We also believe these exposures fit our portfolio well.

In Property, the close cooperation between actuarial and underwriting teams in Bermuda continues; for example, with underwriters being helped by the actuarial department to assess potential market share losses in various loss scenarios. We are actively marketing our capabilities in some areas such as Europe, where we believe there are some opportunities for some modest growth.

The outlook for pricing is consistent with our prediction at the beginning of 2012. The shock losses of 2010 and 2011 are largely forgotten. Balance sheets are repaired and even with Sandy, reinsurers are hoping to keep pricing flat in 2013 outside of loss-affected areas.

Some are insisting that diminished investment returns require them to secure greater margin from underwriting results but we are skeptical about how disciplined the market can be when supply exceeds demand.

We continue to look at opportunities to capitalize on our excellent underwriter reputation at Lancashire that we built over seven years. We deal with a weekly if not daily procession of pension funds, hedge funds and private equity companies, all looking for improved yield and non-correlated diversification in the insurance and reinsurance space.

Lancashire would be foolish to ignore the trend of increased convergence between the capital and the insurance markets as we have a good track record with Sirocco, Accordion and some private deals where we found products to fill a niche requirement.

We will continue to work with sophisticated investors to develop products where we can leverage our underwriting and marketing expertise to create value for the Lancashire brand and shareholders. We will always do this without sacrificing our core business. I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Alex. Hi everyone, our results are laid out on our website as usual. While we are certain we will have an impact on our Fourth Quarter results from Sandy, the Third Quarter was reassuringly dull in terms of major loss activity and we had an excellent underwriting performance producing an underwriting profit of $94.5 million and a combined ratio of 48.9%.

Investments also performed well with the return of 1.1% for the quarter. Our return on equity was 5.7% bringing us to 13.2% for the year, and a compound annual return since inception of 19.4%.

I appreciate that most of you listening probably have more interest in our Fourth Quarter results than our Third Quarter now, but I'm afraid, as Alex alluded to, that I can't give you an estimate of the impact to Lancashire from Sandy as yet, as it's simply too early to tell. The people impacted by Sandy are still picking up the pieces and trying to get back to normal, and it will be some time before the magnitude of the loss can be quantified.

We do have exposure on our Property book in our retro and cat portfolios and in what's left of our D&F portfolio but we'd expect any loss to be contained in earnings. To reiterate Alex's comment, we have some ILWs in place which trigger at a $20 billion initial loss level. We also have the benefit of our recent debt issuance which gives us some extra headroom that we had planned in keeping into 2013 anyway, to see how we can best put it to work.

As a result, Sandy hasn't really impacted our views on our capital level or needs for 2013. We think we have sufficient capital to absorb our loss, provide support for the North East market following the loss, and still be able to pay a nice special dividend this year. That said, our special dividend is probably a little lower than it might otherwise have been.

So we have declared a special dividend of $0.90 per share for approximately $173 million in total. We're paying this out on December 19, so Merry Christmas to all our shareholders.

I think our market outlook is fairly well known, so a large special dividend was widely expected, despite Sandy. As you've heard from Alex, our view at the moment for 2013 is for a decent market with pockets of opportunity but we're certainly not in a spectacular market.

Our debt issue is an opportunistic play, a nice-to-have, given current pricing in the debt markets, and now looks very well timed, albeit unintentionally so.

As I mentioned, this gives us more excess headroom than we would typically carry into 1/1 renewal, to take advantage of any market changes that we aren't currently anticipating; and also enhances that capital mix and efficiency so we should get an incremental boost to our ROE as well.

As we move through both assessing our losses from Sandy and the 1/1 renewals, we will, as ever, review our outlook and capital requirements and adjust accordingly.

So on to the more regular stuff. On premiums, Q3 is typically a light quarter with most of our business typically being written in the first half of the year. Even with that, we are about 20% down in the Third Quarter of 2011 (sic) and that is really down to just a couple of things.

Firstly as we mentioned in last quarter's call, we ceased writing D&F business on July 1. Our D&F premium for the quarter has therefore been just a couple of million dollars and is about $10 million behind Q3 2011. That's an impact that you'll continue to see for the next couple of quarters as that book runs off.

The other big driver was a reduction of, again, about $10 million in our Property cat book and that is largely due to the inclusion of about $9 million of Japanese business in the Third Quarter of 2011 as it extended a number of contracts from the traditional April 1 renewal to July 1, following the March 2011 earthquake and tsunami. Those contracts this year renewed on the normal time of April 1.

We wrote a little bit of retro this quarter, possibly a little more than we were expecting, as we wrote some life cat last year which doesn't renew. But we saw a couple of distress purchases out of Asia that brought us back up to last year's levels. We also renewed a couple of our Accordion qualifying contracts, about $4.5 million, so ceded about $3.9 million to the sidecar.

The worldwide single (shop) product remains well priced, but it does have a significant capital usage on our own balance sheet. As a result, and given our investment partners' appetite to continue with Accordion, we increased our one-quarter share to the vehicle to 100% versus the 85% previously ceded. That won't really kick in until the January renewals though, and everything else remains the same, with a 4% overrider, 13.5% profit commission and 20% investment; so we still have the benefit of all those for Lancashire.

Richard has mentioned our new alternative capital vehicle, Saltire, and that's a 1/1 play, so you won't see anything in the books until then.

As in prior years, we don't give specific top line guidance, but I would anticipate our 2013 gross and net premium to be a bit behind 2012 levels. Our outlook is reasonable but we'll be coming off some of the more distressed retro deals, we've ceased writing D&F, and also, therefore, buying the reinsurance protection that went with that.

Some of the PML for those lines will be redeployed into property cat opportunities though, and we also have our new satellite line of business. Our new debt capital can also be opportunistically deployed as appropriate.

Back to the current numbers, on reserves, the main cat losses to the industry in the Third Quarter were related to crop and Hurricane Isaac. As we said last quarter, we don't have much crop exposure, as we write only a small amount. We've total exposure of around $20 million, and we've booked about $1 million this quarter. We've nothing reported today on Hurricane Isaac, and not expecting to see anything there.

In the current accident year, we actually had very little reported, plus some good news on potential losses for US hail and tornado that we reserved for earlier in the year. Unfortunately, we actually saw a little bit of adverse development on our prior year reserves this quarter. It's only $1 million and it happens from time to time, although we'd obviously prefer if it didn't.

This development relates primarily to a late-reported claim on an old contract, impacting the 2008 and 2009 accident years. Small numbers in the scheme of things, but other than a little IBNR for Hurricane Ike, we've pretty well released all the IBNR in those years, so the development comes right through. We didn't see any significant development on our reserves for other prior major events.

Our investment portfolio did well this quarter, with the impact of central bank policy in both Europe and the US impacting performance. We produced a total return of 1.1% for the quarter, with a nice contribution from our emerging market debt portfolio and also our US corporate debt, as a result of the spread tightening in the quarter. That brings us to 2.8% for the year, which we're pretty pleased with, all things considered.

There's not a whole lot more to say on investments other than we're slowly funding a small bank loans portfolio, and expect that to be around 2.5% of our portfolio by the end of the year. We've also invested the proceeds from our debt issue in surplus and corporate mandates. However, our focus is still very much on minimizing downside risk so there won't be any significant changes in our portfolio structure.

Our equity-based comp and G&A dollars probably look a little high this quarter relative to trend. Acquisition costs are back in line, after a slight uptick last quarter for some reporting adjustments. The equity-based comp charge is driven, to a large degree, by expectations investing, and given recent performance, we increased some of those numbers. Our G&A includes around $3 million of one-off software expenses.

With that, I'll now hand back to the operator for any questions.

Questions And Answers

Operator

We will now begin the question and answer session. (Operator Instructions) William Hardcastle, Bank of America.

Q - William Hardcastle {BIO 16346311 <GO>}

Should I be viewing your capital position that you'd be happy to run with the same capital base this year versus last year? And by that I'm trying to incorporate the debt into it. So last year you had a -- at full-year-end, you had a capital base of $1.45 billion. Is that what we should be trying to get around to or a little higher?

The second question, actually it relates to Accordion and Saltire. The outlook on -- well, first of all could you discuss your outlook on retro in particular and, therefore, the level of utilization of Accordion next year. Then -- I apologize for going on a bit, but regarding Saltire, what's the key opportunity there, given generally fairly stable pricing, if not a little down? Thanks.

A - Richard Brindle {BIO 1983776 <GO>}

Okay, let me deal with the last bit there and then I'll hand over to Elaine and Alex to -- Elaine for the capital question and Alex for the retro question. The Saltire product is not a product that is currently available in the market and, therefore, is not subject to the usual competitive supply and demand pressures.

We're confident that because it is both an attractive hybrid solution for people, providing cat cover where a lot of the collateralized vehicles entering the market run out because the race online ceases to be sufficient to fulfill their metrics. Allied with this non-elemental sideways aggregate product, which is not only attractive as a sleep-easy product but also very capital efficient within both the Saltire -- both the Solvency II and the A.M. Best models, means that we're not really in a traditional competitive situation trying to price it versus competitors. So we're confident that the product will both be attractive to the buyers and produce a very low expected loss to us.

Why don't you talk about the capital question, Elaine, and then Alex about the retro, please?

A - Elaine Whelan {BIO 17002364 <GO>}

Sure. We've said earlier on this year, that we saw a reasonable market outlook but nothing particularly spectacular for next year, so that we would be likely to return all our profits and run with the same type of capital levels, maybe slightly lower into next year. We did issue our debt at the beginning of October and that was really just because of the availability of it there and the pricing of it because it was a nice-to-have.

So what we intend doing is using that to see if there are any opportunities at 1/1 that we can put capital to work. And if we can't, then we will return it when we no longer have a use for it. So it's the same philosophy as always, outlook drives capital. At the moment we're running with a bit more excess headroom than we would do typically because of that debt raise, but we'll adjust as and when we see fit.

Q - William Hardcastle {BIO 16346311 <GO>}

So just to be clear, Elaine, you'd be happy to run with a lower book value, effectively, but the same capital level?

A - Elaine Whelan {BIO 17002364 <GO>}

Correct.

Q - William Hardcastle {BIO 16346311 <GO>}

Great. Thanks.

A - Alex Maloney {BIO 16314494 <GO>}

On Accordion, our general outlook on pricing for the classes of business that we underwrite is pretty flat, and that definitely applies to retro as well. We are currently talking to the brokers about the renewals that happen on January 1 and we believe -- if you look at a historic basis, we still believe retro's a good product for us to sell. There's still a lot of value in the buyer to purchase worldwide retro.

So we believe that we can keep the pricing flat year on year, and we believe the demand will be there, so that is why we spoke to our investors and rolled Accordion over. So it's very much in line with the rest of the market, we think.

I think -- I really don't want to come across that we're negative on rating. I think that we think it's a reasonable rating environment; it's not bad, and it's flat, and flat can be a good thing. So we're happy with Accordion where it is at the moment.

Q - William Hardcastle {BIO 16346311 <GO>}

Okay. Thanks, guys.

Operator

Ben Cohen, Canaccord.

Q - Ben Cohen {BIO 1541726 <GO>}

Could I ask two things? Firstly, in terms of the ILW protection that you have above a $20 billion loss, could you give us some indication in terms of how much that would net out for you? Presumably, it's not 100% protection above there, but maybe you could give a bit more color on that.

The second thing was on Saltire. Richard, you mentioned that there was something in the structuring whereby investors in Saltire would get attractive returns on their underwriting that current vehicles wouldn't get if they were writing the same business. Could you just explain how that is structured? Is there debt in that instrument in some way that gives leverage or something that I'm -- probably something that I'm missing? Thanks.

A - Richard Brindle {BIO 1983776 <GO>}

That's fine, Ben. Couple of hoops to jump through there. On Saltire, yes, there's preferred in there, which juices up the return for the common equity holders a bit. Elaine can talk about that in more detail. What I'm trying to say about the product is we're not competing against a whole bunch of other collateralized vehicles for the retro, either on an ILW trigger or a UNL trigger.

This is a product that has a combined limit, so it can only pay out once. But that limit can be eroded by either just straightforward cat losses; at a very high level, by the way, much higher than our Accordion book, so there's no merging of the two. There's a big gap between the attachment points in the two vehicles. But then it has this non-elemental side, which I'll ask Alex to talk about a little bit more.

Alex, I think it's fine to give Ben clarity on how much we purchase by way of ILWs.

A - Alex Maloney {BIO 16314494 <GO>}

Yes, sure, okay. We have $40 million of ILW attaching at $20 billion. As I said earlier, it -- we don't have any information at this moment in time, but obviously $40 million will, obviously, affect our net loss. So if this -- Sandy does end up at the top end of some of the commentary we've seen in the market, we should have a nice recovery there, but we'll have to wait and see. So it's very difficult for us to tell you at this point how that will affect our overall loss position, but we are very happy we have that cover in place.

On Saltire, just a couple of other points; our real reason for this product is -- it has to be driven by demand. There's no value in us dreaming up products that clients don't want to purchase. And I think that our industry, the understanding of risk, the understanding of what really drives your capital, I think the industry's just getting better and better, and that's driving reinsurance purchasers and CFOs to change their purchasing behavior.

So I think products like Saltire will become more common. People are looking to cover not only their cat losses; they're looking to -- things like RDSs, particularly in Lloyds are under much more scrutiny than they were in the past. And Saltire offers a client a whole account.

Aggregate products on a UNL basis, there's not basis risk, so again, most clients much prefer UNL versus basis risk. And as Richard said, we're covering cat on one side, the other side we're covering the -- effectively the specialty lines that we underwrite at Lancashire. So part of our sell to the investors was on the specialty side of the piece; we think with our track record we can really understand some of the clients that are going to purchase Saltire from us, which will probably be people in Lloyds. We know these companies very well. We see their underwriting on a daily basis. So we believe that we'll get a very good level of detail and understanding of a product such as this.

Q - Ben Cohen {BIO 1541726 <GO>}

Great. Thank you.

A - Richard Brindle {BIO 1983776 <GO>}

It's just worth mentioning also, Ben, that the non-elemental side does not cover standalone casualty. There'll be a little bit of incidental casualty in the Marine exposures. But it's short-tail vehicle.

Q - Ben Cohen {BIO 1541726 <GO>}

Right. So you will define what sort of perils would be covered in that quote quite closely?

A - Richard Brindle {BIO 1983776 <GO>}

Yes. There'll be a nice miss factor with the clients, because you might include some major Lloyds syndicates writing a whole bunch of short-tail lines of business, and you'd attach excessive, multiple losses. This thing will not respond to the first or even the second loss; it's a -- like I say, it's a very, very bad day in the office when this policy responds, which is why it has such a low expected loss.

But it's attractive, because it's a sort of sweeper, if you like, for a syndicate writing a whole bunch of lines of business. And it also is very capital-friendly, due to the early adoption of Solvency II by Lloyds. It's -- for reasons which are extremely complicated, and I'm not clever enough to tell you, it is very -- something that a CFO will look at and think, yes, that's great.

So we tried to look at it from the traditional and the non-traditional angles, and it ticks both boxes.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thank you.

Operator

Chris Hitchings, KBW.

Q - Chris Hitchings {BIO 2034501 <GO>}

Just a couple of questions. You mentioned that the ceding to Accordion was raised to 100%. Can you -- firstly, is that a permanent change, i.e., does that go forward from 1/1/'13 as well?

Secondly, can you talk me through the thinking behind this, and particularly from the point of view of Lancashire shareholders, as opposed to the shareholders in Accordion, how did you, as it were, reconcile this?

Second boring accounting question, how will you account the premiums written by Saltire? Will this be as gross premiums to Lancashire and ceded out? Or will it be a separate entity?

A - Richard Brindle {BIO 1983776 <GO>}

Okay, Chris, let me take the first of those and then Elaine can take the second.

The reason that we deleted the cession for Accordion was because of really -- because of our exit from D&F. If you think about Property writings as a spectrum from D&F, through property cat to retro, D&F is fairly light on premium and high on parameter risk. But obviously, not in any way a binary product that's all going to respond to the same event.

Property cat's somewhere in the middle, and then retro's high rate online, binary, but no parameter risk.

Now taking the D&F off the table as we've done, and by the way I think it was a good decision. We've heard anecdotally from others in the market that they applaud our move, because it is a very ill-disciplined market, and gives a lot of coverage away for nothing. And I think that's going to become very apparent as Sandy unfolds, both through the direct D&F writings and stuff like binding authorities, which I think we all know are going to take a pounding from Sandy.

Yes. This stuff like (cloud), BI, CBI, even terrorism, is all effectively thrown in for nothing, and that's why we lost patience with D&F, and exited it, although we did it with due dialog and cooperation with brokers to make sure that we didn't cause too much disruption.

But once we'd taken the D&F off the table, Chris, our Property portfolio would have been far too weighted towards binary events, had we not adjusted our retro -- our retained retro exposures downwards.

So we spoke to the investors who fully understood; and they agreed that we still had skin in the game via our investment, so that it was logical and appropriate to delete the retention.

So I think you can expect that to answer the second part of your question, to be a permanent change, because we don't anticipate us re-entering the D&F market any time soon.

Elaine, perhaps you could answer the second part, please?

A - Elaine Whelan {BIO 17002364 <GO>}

Sure, hi Chris. Saltire, it's a little bit different from Accordion, where we write directly on our balance sheet and cede with Accordion, Saltire is a market-facing vehicle. So there won't be any impact on our premiums and our ceded premiums.

We do have an investment in the vehicle; we've got 20% in there. So you'll see an equity pickup coming through there the same way that you'll see the equity pickup coming through in Accordion.

And we'll get an underwriting fee for the services that we're providing to the vehicle, so you'll see that coming through. And that won't be in the technical account, that will be outside of it, because it's not a commission, it's a fee (source) with a profit commission ultimately on the vehicle as well, (if all things prove well).

Q - Chris Hitchings {BIO 2034501 <GO>}

Yes, can you -- just a follow up from that. Firstly, Elaine, congratulations on your promotion, excellent. But as a follow-up to that, the fees for Accordion come through in the expenses line, or rather the commission line. And I have to admit, rather optimistically, I assumed that 2012 might see expense ratios decline because of this; and they haven't, they've actually gone up.

Can you give us some quantification of what fees are coming through? Clearly you haven't booked any -- presumably you haven't booked any profit commissions yet. And when you talk about how the fees from Saltire will come through, as you said there'll be a separate line as fee income. And will the profit commissions come through, if any, on the same basis?

A - Elaine Whelan {BIO 17002364 <GO>}

Sure. The fees on Accordion do come through the commission income. The reason for the expense, or the commission, the acquisition cost ratio moving around a little bit, is driven by changes in our reinsurance program, it's driven by changes in business mix. It's driven, sometimes, just by some endorsements coming in and some adjustments running off of them. So it does move around a little bit, but overall it's just going to run at trend.

We get 4% in terms of our override commission for Accordion, and it's 13.5% for the profit commission; and the profit commission, we haven't recognized any of that yet, it's contingent. So it will be a little while before we can start booking that.

On Saltire we will have the underwriting fee and the profit commission coming through. Again, the profit commission will be after the fact. It will be once we know that the vehicle's run clean.

Q - Chris Hitchings {BIO 2034501 <GO>}

Okay, fine. Is there an accounting correspondence between how the profits are booked in Accordion and Saltire, and how the profit commissions are booked?

A - Elaine Whelan {BIO 17002364 <GO>}

Sorry, Chris, I'm not sure that I understand.

Q - Chris Hitchings {BIO 2034501 <GO>}

I.e., do you book a -- if you book a profit in your accounts from Saltire, is that, does that trigger the booking of a profit commission that would be earned on those profits?

A - Elaine Whelan {BIO 17002364 <GO>}

Ultimately yes. What we'll do is we'll pick up our portion of the profit as the vehicle runs through next year. Then after next year, when we're looking at the profitability of the vehicle, and calculation of profit commissions, we'll book that then. So it'll come through after next year.

Q - Chris Hitchings {BIO 2034501 <GO>}

Okay, fine. So there isn't a conversion. Fine, thank you.

Operator

Olivia Brindle, Barclays.

Q - Olivia Brindle {BIO 17273762 <GO>}

Just a couple of questions again on Saltire. So the first one, and I'm playing devil's advocate here a little bit. I recognize the benefits and the opportunities associated with it, but it does start to change your business model a little bit. And you've talked generally about getting more exposure to fee-type earnings. The increase of the cession to Accordion also seems to be going that way.

So I get the sense that you're trying to extend the scope of the business a little bit, perhaps given that your current model of not being driven by top-line growth is perhaps a bit of a constraint in that regard. Is that a fair way of looking at it? And if so, should we read anything into this? Is it the start of a more fundamental shift? So that's a kind of high-level question.

Then secondly, also, on Saltire, can you give any indication of the level of fee and commission proportion on that, and will it be similar to Accordion?

Then finally, given that it will provide a higher base of fee income, should we therefore expect an increase to risk appetite on catastrophe business to follow from that? Thank you.

A - Richard Brindle {BIO 1983776 <GO>}

Okay, Olivia -- good questions. Take the last bit first, do we expect an increase to catastrophe exposures? No. We are -- as you know, we have hard-line tolerances for certain events, and the US wind, US quake, etc. And nothing will change.

Just because we are doing these vehicles doesn't mean we're suddenly going to push up to those tolerances either. We would anticipate our cat exposures will remain broadly the same next year.

I would think about -- think about just a change in the mix. The D&F has come out for reasons I've just said to Chris. We really, really dislike that product now, and we think other companies should be having a long, hard look at it, frankly, particularly after Sandy's just reminded us of how much coverage is thrown in for nothing.

That will obviously be coming out of our PMLs, and the Accordion retention will be coming out for the reasons I just explained to Chris. Then there'll probably be some increased property cat exposures where we see some opportunities, and obviously the retained exposure in Saltire. But I think, broadly, cat exposures will stay the same.

Q - Olivia Brindle {BIO 17273762 <GO>}

Okay.

A - Richard Brindle {BIO 1983776 <GO>}

On fees, up to you, Elaine. I'm happy for you to tell Olivia, but I'm not sure if we legally can with the investors yet, given it's just been signed. So I'll defer to you on that. But if we can tell you, we will tell you.

But to get back to your fundamental question, which is what I tried to cover really in my opening remarks. This is not a fundamental change in Lancashire, but it is an evolution.

There's no doubt our industry is evolving. You've got $30 billion of non-traditional capital now. Under 10% of that is run by seasoned people, like us. A lot of it is run by neophytes who are good, smart people, but not part of our rather strange London specialty world. And I'm not in any way demeaning those individuals, and I'm sure they're very good at their job.

But I think in the long term, it makes much more sense for this capital to be deployed behind companies like Lancashire. You have the ability to do all the analytic, technical side, but also the ability to look people in the eyes, and really understand what they're like, and how they operate.

Alex talked in his remarks about how well we know the companies who are going to be buying Saltire. Don't forget, we operate in a subscription market with these guys, so we're seeing deals every day, where the sort of people who'll be buying the Saltire product, are writing lines alongside us.

It gives us a real edge, I think. Part of my responsibility, as CEO of Lancashire, is to make sure that we do not stand still, and that we evolve as the world evolves. And there's no doubt this money -- some of it will probably disappear if there's a big loss, but this new money is here to stay. And I think companies who just ignore it are in danger of looking a little flat-footed.

However, there is a balance to be struck here. And the one thing I've made very clear, speaking to investors on the road about Saltire, is that we will never do anything with these vehicles which will mean that the mother ship will suffer.

We do have our core business at Lancashire, and it's a wonderful core book of business. It's probably $500 million to $600 million, no, probably $550 million to $600 million worth of premium, which is based on core relationships, in both the insurance and the reinsurance books.

These are people we visit, who visit us. We know them really well. We write across different exposures for them. The brokers are fully embedded and respected in all of these relationships. And that's our bread and butter, and it's produced a combined ratio in the 60s, since inception, and has driven -- been the primary driver of the very large capital we've been able to create and return to shareholders.

Nothing's going to change. This other stuff is nice, and it's appropriate that we do start to develop a fund management side to our business, but you can be -- you can rest firmly assured that I will not allow any of this stuff to impact our relationships with our core clients, or indeed, the size of lines we're able to offer them. Because that's just the key bedrock of Lancashire, and will always remain so.

Q - Olivia Brindle {BIO 17273762 <GO>}

Okay. Thank you. Just a brief follow-up. Looking forward long term, what proportion of earnings would you be comfortable to come from this part of the business? If it was 50% of your net income, would you be happy with that, or is there some kind of cap that you would have in mind?

A - Richard Brindle {BIO 1983776 <GO>}

Well we're nowhere near that sort of stage. Elaine, feel free to dive in here. 50% would be wildly above anything I would anticipate in anything approaching the foreseeable future. But Elaine, feel free to jump in.

A - Elaine Whelan {BIO 17002364 <GO>}

Yes. This is the kind of stuff that you'd expect to maybe be adding a point or two to our ROE, and nothing much more than that. So we might have two or three vehicles running at any one point in time, but probably not a lot more than that.

Q - Olivia Brindle {BIO 17273762 <GO>}

Okay. And the --

A - Richard Brindle {BIO 1983776 <GO>}

About fees, Elaine?

A - Elaine Whelan {BIO 17002364 <GO>}

Sure, no problem in disclosing them. Our underwriting services fee is 5.5%, and our profit commission is 18% over our hurdle. It's a little bit different from Accordion, it's a more labor-intensive product, and there's a difference in the fee structure that we have on it there.

Q - Olivia Brindle {BIO 17273762 <GO>}

Okay. Thank you very much.

Operator

(Daval Garda), Morgan Stanley.

Q - Daval Garda

Just to follow up on -- take over from Olivia's question, I just wanted to check what is the size of business that you think Saltire could grow over the next couple of years?

A - Richard Brindle {BIO 1983776 <GO>}

Well it's a one-year vehicle, and it can accept policy limits of up to $250 million. We've deliberately structured it as one year. We -- I think we learnt from Accordion that rolling over and all the issues associated with it can be very complex and time consuming.

And we have every faith that it will be a multi-year opportunity, because we think it's such an attractive product, but we're not bound in beyond 12 months for now. So we'll take a look at it in a year's time, and see how the market looks, and in all likelihood we'll then do a son of Saltire for 2014.

Operator

William Hardcastle, Bank of America.

Q - William Hardcastle {BIO 16346311 <GO>}

Just a quick one on the cat exposures staying the same. Can you just confirm, are your tolerances as a percentage of capital base, or is it a percentage of equity base?

A - Richard Brindle {BIO 1983776 <GO>}

Of capital, but I'll let Elaine answer that more fully.

A - Elaine Whelan {BIO 17002364 <GO>}

I don't have a fuller answer on that one, Richard. Yes. It's based off of capital.

Q - William Hardcastle {BIO 16346311 <GO>}

Great. Thanks.

Operator

(Operator Instructions) We have no further questions at this time. I will now turn the call back to your host.

A - Richard Brindle {BIO 1983776 <GO>}

Yes. Thanks everybody for dialing in, see you next quarter.

Operator

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