Q1 2016 Earnings Call

Company Participants

- Alexander Maloney, Group Chief Executive Officer & Executive Director
- Elaine Whelan, Group Chief Financial Officer & CEO-Lancashire Insurance Company Limited
- Jonny Creagh-Coen, Head-Investor Relations
- Paul Gregory, Group Chief Underwriting Officer & CEO-Lancashire Insurance Company (UK) Limted

Other Participants

- Ben Cohen, Analyst
- Kamran Hossain, Analyst
- Nick Johnson, Analyst
- Olivia Brindle, Analyst
- Thomas Fossard, Analyst
- Thomas Seidl, Analyst
- Xinmei Wang, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day and welcome to the Lancashire Group Quarter One 2016 Results Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Alex Maloney, Group Chief Executive Officer; Mr. Paul Gregory, Group Chief Underwriting Officer; and Ms. Elaine Whelan, Group Chief Financial Officer. Please go ahead.

Alexander Maloney {BIO 16314494 <GO>}

Okay. Thank you. Thanks for dialing in, everyone. We also have Richard Williams, Active Underwriter of Cathedral; Darren Redhead, CEO of Kinesis; and Denise O'Donoghue, Chief Investment Officer on the call for questions.

I'm pleased to report that we started 2016 with a strong return on equity of 3.8% for the first quarter. Our combined ratio is 72.7% demonstrates the quality of our portfolio and our total commitment to underwrite the cycle. As we've always stated, we are underwriters first and foremost. So we will continue to focus on underwriting excellence, efficient capital management, and managing our investment portfolio in a conservative manner.

We have adjusted the amount of insurance risk that we currently hold as we embrace the current environment. We even enhanced our reinsurance program at the 1 of January and believe that we have the right risk-adjusted return for this stage in the cycle.

So I'm satisfied that we continue to demonstrate our ability to add value for our clients and brokers in this challenging market. We have said many times before, unless, you are relevant, you really are going to struggle to make any acceptable return for your shareholders in the current underwriting environment. We have experienced a period of change at Cathedral, our Lloyd's business. I see this is a natural evolution of the business as certain incentives mature and a period of opportunity for the next generation of leaders will be in that business.

I'm delighted that Richard Williams has assumed the role of active underwriter, subject to the necessary approvals. Richard is supported by an experienced team of colleagues, many of which have been with the Lloyd's business for the last decade who will assist him with the continuation of excellent underwriting contribution, which Cathedral provides to the Group.

We've also made new underwriting hires who will underwrite the North American property cat portfolio and the international property cat portfolio. All three hires have been chosen for their in-depth experience in dealing with the specific customer and broker base. We'll be able to publicly announce them in the near future. Lastly, I would like to welcome Heather McKinlay to Cathedral. Heather will assume the role of Chief Financial Officer, again, subject to the relevant approvals.

So we have a lot going on, all of which, I believe, is positive for the Group as we evolve as a business. We have been through periods of change before, and this is no different. I'm delighted with the reactions of people who work for us. And this period of change has opened the door to many conversations, which we continue to have. We see no immediate change to the current underwriting climate, but we do believe that things will change when capital is impaired. With low margins in cat for years, we believe that not much needs to tap in before the industry is in the red. This in itself may not change things immediately, but we do believe that shareholders across the insurance sector will not accept low returns indefinitely.

I'll now pass over to Paul Gregory.

Paul Gregory {BIO 16314515 <GO>}

Thanks, Alex. Good afternoon, everyone. Once again, I'm pleased to report an excellent quarter from an underwriting perspective with a combined ratio of 72.7%, demonstrating the quality of the underlying portfolio. In this benign loss environment, you wouldn't really expect the combined ratio to be within 100%. Having a healthy margin certainly gives us a degree of comfort when market losses return to historically normal levels, which will no doubt happen at some point. The market across almost all of our business lines continued to suffer through the course of Q1. We'll be (04:06) of changing certain lines. In particular, U.S. property cat has certainly slowed.

Premiums across the Group are broadly in line with expectation, given the market dynamics in each class. Premiums in the Lancashire property in Aviation portfolio have remained robust, offsetting reductions across Marine and Energy. Rate reductions continue in the challenging energy market, and we anticipate similar levels of rate reductions through Q2.

As expected, premium levels are also impacted by lower values in activity; however, we've been successful in maintaining and improving our shares on the core portfolio. (04:44) premiums year-on-year reduced in line with expectation, given rating trends and the continued disciplined underwriting approach. Property reinsurance premiums are reduced in line with rating movements, with the portfolio remaining static. Whilst market conditions in Aviation and Property Direct and Fac have maintained (05:02) certain rate of decline to protect the profitability of the book.

I'd like to thank everyone in Cathedral for their hard work, dedication, and professionalism over the past few months, ensuring that our clients and brokers have had a business-as-usual service. And this has meant that our trading at one (05:19) full has remained in line with expectations. We also thank our clients and brokers for their continued support, which was not unexpected, it's greatly appreciated.

As Alex has mentioned, we've made a successful start, recruiting new talents in the syndicate, which is both pleasing and demonstrates our commitment to the business. Just as pleasing has been the continuation of our historic ability to promote from within and allow younger talent the opportunity to take on more responsibility and more challenge. As a business, we've always encouraged this and benefited as a result.

Absent any significant market losses, we fully expect the market to remain challenging through the remainder of the year, our core book of business and pool of talent within the group positions us very well. We have the ability and the platforms to maximize opportunities as and when they arise in the future.

I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Paul. Hi, everyone. Our results are in our website as usual. Given the market environment we're in, we're delighted with our first quarter results. With strong underwriting performance in both the Lancashire and Cathedral platforms, ROE for the quarter was 3.8%, with Cathedral contributing 1.2% of that. With a quiet quarter for losses and some reserve releases, our loss ratio is 29.6%. Our investment portfolio also performed well in incredibly volatile market, producing a return of 0.7% for the quarter.

So, many of our key metrics this quarter looked very similar to our Q1 2015 metrics. The reduction in comprehensive income quarter-over-quarter. There are a few moving parts this quarter, and I'll get into more detail on those. For our high level, investment returns were good, but down a bit on last year and rest is due to prior year recoveries and the tightening of receipt of profit commissions. While underwriting income was a bit behind last quarter, you may recall that we received additional recoveries on the settlement of a large Thai flood loss claim in Q1 2015, which boosted underwriting income for that quarter.

As I mentioned last quarter, the impact of the large number of multiyear policies written in 2014 has largely run through the top-line now, so there is much less impact from them. On the Lancashire book reductions in energy and marine premiums is due to rate, and the tightening of non-annual deals were offset by increases in the property book which in new business, the property cat and the (07:45) book.

Cathedral maintained a core book that have some further reductions across most lines of business with rates continuing to soften. Our one-fourth property cat and energy offshore renewals in Lancashire space held up reasonably well, with premiums just a little bit behind the prior year.

Cathedral continues to see some further rate pressure with the magnitude of premium reductions in line with the first quarter. We expect pricing pressure to continue over the rest of the year but expect Q3 and Q4 premiums to come off a bit. But, as Paul has said, the pace of rate reductions is slowing, there shouldn't be a significant impact. Also, about 65% to 70% of our book is written in the first half of the year.

Our ceded premium is a little lower than Q1 last year, but for the full year, I would expect it to hover (8:32) around the same level spend as last year, as both Lancashire and Cathedral continue to buy more cover savings from price reductions on our program.

Our acquisition cost ratio is in line with expectations for the quarter and also for where we expect to be for the year. On losses, as I mentioned, that's been a quietish quarter and we had some favorable developments. We had a couple of mid-size energy losses that we reserved in the quarter and those have pushed our accident year loss ratio up a little to 42.5%. If you strip those out, our attritional ratio is still in the mid-30%s.

We had $17.7 million of favorable developments in the quarter compared to $26 million last year, with the difference being largely due to the Thai flood loss recovery I mentioned earlier. Otherwise, in both quarters, we're just releasing IBNR due to lack of any reported claims.

Investments, including our currency hedging, returned 0.7% for the quarter, with most of that coming from our fixed maturity portfolio. Our hedge funds were negatively impacted by the volatility in the quarter, that was almost entirely offset by positive returns from the bank loan portfolio. Our interest rate hedge and any gains or losses on hedge fund redemptions are included in the net realized gains, losses, and impairments stated (9:46) in our income statements.

The large negative (09:49) this quarter is a result of us realizing losses and some redemptions in our hedge fund portfolio and to slightly reposition that, plus the movement on our interest rate hedge and some impairments. The mark-to-market on our hedge funds goes through other investment income and the negative there is a reflection of the performance for the quarter. The rest of our portfolio mark-to-market goes through comprehensive income. Overall, our diversification and interest rate hedging are serving us well. We will continue to manage our interest rate risk over the rest of this year and will stay fairly short duration under the same level of risk assets.

Other income captures our third-party capital income. The reduction this quarter is due to the tightening of receipt of profit commissions from Kinesis as we wait for some collateral to be released. We anticipate receiving about another $4 million over the rest of the year on the 1/1/15 underwriting cycle. As before, underwriting fees from Kinesis are earned in line with the underlying risk profile, so you see most of that come in over the next couple of quarters.

As there are no losses in the 1/1/16 underwriting cycle, profit commissions could be just under $6 million (10:58) with the Q1 2017. Lancashire's G&A includes KCM expenses. While our overall G&A for the quarter is in line with expectations, it does include some additional compensation expense in relation to previously announced Cathedral direct (11:14) departure.

Employment costs are therefore slightly higher with other expenses are down a little due to reductions in some IT projects and consultancy costs. Reductions in the stock comp costs due to RSS awards lapsing on departures were offset by an increase in performance assumptions.

Our financing expenses were negatively impacted by the mark-to-market on our interest rate swap and we also had an additional expense of just under $1 million this quarter for the renewal of our credit facility. Ignoring the swap mark-to-market, our financing costs still tend to be around $4 million a quarter.

The small tax credit for the quarter is driven by combination of some prior period adjustments and some group release taken.

Finally, on capital. As I said last quarter, we are targeting around $1.35 billion to $1.4 billion of capital for 2016. So we will continue to monitor that closely as the year develops. If something happens to change the market this year, then we're likely to return earnings at the end of the year.

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

Q&A

Operator

Thank you. We'll pause for just a moment to allow everyone to signal. Our first question is from Kamran Hossain from RBC. Please go ahead. Your line is open.

Q - Kamran Hossain {BIO 17666412 <GO>}

Hi. Good afternoon, everyone. I've got three questions. The first one is just on your PML. So it looks like the Japanese exposure has increased to April 1 up from 1st of January. Is that down to kind of increase in Japanese premium that we should expect to come through in Q2? That's question one.

The second question is just on reserve releases. If I look at the size of the reserve release compared to your – as a percentage for your opening net reserve, it's just over 2.5%, so, annualize at 10% of your (13:32) net reserves. I guess if the book has shrunk, should we expect larger reserve releases as a percentage of net earned premium to come through?

And the third question is probably one for Alex. But, just on Cathedral, now that you're kind of more involved with the day-to-day running of the business, are there any areas that you think can be improved or kind of brought more in line with the way that Lancashire does things? I'd be really interested in any thoughts there. Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Kamran, so, yeah, obviously, I'll take the three, and then Paul will do the Japanese one and then Elaine will do the reserves. So I think my view of Cathedral is nothing's substantially changed. Obviously, we've had a number of departures. Richard Williams, who sit next to me, has stepped out to Active Underwriter that the group continues to use that business, and it's provided opportunities for other people internally to have a bigger job than what they had before. So, I think that's good. That's always been the kind of the Lancashire-wide, not much changed at Cathedral over the years because that was a very stable business. And obviously, when things have changed, that creates opportunities for other people.

I think our Lloyd's business, the Lloyd's model is very different to the business outside of Lloyd's. So, I don't see why we would change anything that makes sense. That business is good. It's profitable. The people there are very good. But where I do see we can do some things, I think we can get closer together. And I think there are, probably, opportunities around some of the reinsurance buying that we do as a group, and I think we could get better at leveraging the spend we have in a market.

As we have said many times before, we have put more reinsurance as a group. We think that's the right thing to do at this stage in the cycle. Have we leveraged that enough? Probably not. So, I think we can look at that. Obviously, I'm not proposing for one second that we would buy less reinsurance. I just think we could probably get better doing that.

And then, there'd be some small things, maybe, where we can get more efficient work closer together, but there's no grand integration plan here. We're going to do everything that makes sense, not change anything where we don't need to. But there's definitely things we can do as we work closer together.

Q - Kamran Hossain {BIO 17666412 <GO>}

Fantastic. Really appreciate your thoughts. Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Thank you.

A - Paul Gregory {BIO 16314515 <GO>}

Hello, Kamran. And on Japan, yeah, we've been really pleased actually. We've had one full win across the group. We've got Japanese renewals both at Cathedral and in Lancashire, Bermuda. I mean, over the last few years, as you know, we've established quite a presence in Japan and we had a number of our core clients come to us this renewal season, and offers the opportunity to have bigger participations. And we have on some occasions done that. We think it's good business. The rating environment wasn't too bad. It's about 7.5% off. So, you might not necessarily see an increase in premiums because some rates have been turned off. (16:44).

We also hired a new guy at the tail end of last year who (16:51) properties in Japan which has helped us develop some new relationships. So overall, renewal season at one for both at Cathedral and at Lancashire, Bermuda was very strong which we're very happy about. That's obviously a very core part of our property cat portfolio.

Q - Kamran Hossain {BIO 17666412 <GO>}

Thanks, Paul. Appreciate the thoughts.

A - Elaine Whelan {BIO 17002364 <GO>}

And then on the reserve releases, I think we've said in the past not to read anything into reserve releases in any given quarter. So, it was nice to have them. But sometimes things go the other way. A lot of it through last year we were just releasing IBNR over the course of the year. We weren't see much report coming through from 2013 and 2014 and the same is going to happen this year so far. We're not seeing much coming through on 2014 and 2015 years, so we're really seeing a little bit off of those years. We do have high attritional rates for the new parts. In previous years, we've been gaining to our income to the mid-30s on that and then these lower earnings (17:52) given where we are in the cycle. And we don't really tend to work out really seasonal run rate on that.

Q - Kamran Hossain {BIO 17666412 <GO>}

Perfect. Thanks very much, Elaine.

Operator

Our next question comes from Thomas Seidl from Bernstein. Please go ahead. Your line is now open.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. Thank you. Three questions. The first is on capital management. I wonder what the rationale is for a bit more modest payout ratio this quarter, like 62% on operating earnings. You mentioned the price pressure is unchanged at minus 10% across the portfolio. And you also just renewed the preemption, the 15%, you can take. So, what kept you, basically, from further bringing down the capital in line with the business opportunity? That's my first question.

Second is on these realized losses impairments. Could you break down those $7.9 million into the hedge fund, interest rate hedge and impairment part? And also comment, should we consider all three to be one-offs, or is there more to come in the impairment or in the hedge fund portfolio?

And the third question is a bit more prospective looking into Cathedral. I understood that you might want to use the more efficient environment of capital to ride more out of this platform as opposed to the Lancashire platform. At the moment, I'm not seeing this happening. So, what are your thoughts further exploiting Cathedral, the efficient platform you have there?

A - Alexander Maloney {BIO 16314494 <GO>}

Okay, Thomas. So, Elaine, will do one and two. I think on your point three, I think the way you think about any business is, if you think what we've got, we've got three platforms, we've got Lloyd's platform, outside of Lloyd's like the old Lancashire and obviously Kinesis. So, we're always going to place the business where we see fit and where the client – what pipe the client wants. I think what we had is the optionality to place more business in Lloyd's if that makes sense. I think, obviously, we put it on a couple of years ago, and now, we're starting to write some energy business in Lloyd's, (20:09) business in Lloyd's.

But there's a wholesale shift to put business in Lloyd's. If that opportunity came up, we would do it. If it made sense, we would do it. I think more than anything, the point I'm trying to make is I think having the options of three platforms, we think, is the perfect structure for us as a business. The product that fit within Lloyd's, and we spoke before about underwriters that we now have a Lloyd's home to attract certain underwriters that we didn't have before. So, we have options. I think it's a fair criticism of ourselves that we haven't done enough of that, we haven't attracted enough of those underwriters and that's what we will hopefully focus on going forward. But there are no grand plans to put huge amounts in the business into Lloyd's. But (21:01) we wouldn't do if it made sense, but it's just having those options is the beauty of the three platforms.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yes. And on that one, just one follow-up, I might have thought that the capital consumption for the business you do might be lower under the Lloyd's umbrella rather than under the Lancashire platform, but maybe not.

A - Alexander Maloney {BIO 16314494 <GO>}

So, I think if you put the whole business into Lloyd's, that's probably a true statement. But I think whilst we had various different platforms, I 'm not sure it will make a massive material difference to us. And obviously, as Elaine said, the kind of the capital that we're targeting supports what we want to do for the whole business and our ratings, et cetera. So, I think you're right, if you put everything into Lloyd's, you're going to need less capital. But clearly, like any strategic decision there, there's pluses and minuses to doing that. And what I'm saying today is I still believe having three platforms is the best model for us.

Q - Thomas Seidl {BIO 17755912 <GO>}

Okay. Thank you.

A - Elaine Whelan {BIO 17002364 <GO>}

And on the impairment side, there's obviously a little bit more moving things around this quarter, which I think is probably confusing. But a lot of it is geography. We've taken some stuff out of unrealized gains and losses and comprehensive income. And it's now being realized in the income statement. And we did some impairments last quarter. We have that smaller proportion of the numbers that you're seeing there. Actually, most of the numbers you're seeing there is the mark-to-market on our hedge and our investment portfolio and interest rate. And that moves around as yields move around. And that's about half, there is a bit of impairments than it's a little bit on the hedge fund, still particularly a bit of the hedge fund last quarter kind of done with that, but we positioned a little bit on that.

On the payout rate, I'm not entirely sure I understand your question. But let me try and answer what I think you are asking. We did a large dividend at the tail end of last year. And in the past, it's split down and done a bit at the end of that year and a little bit in Q1, which also did all of it in one go last year. Then, we're fairly solid in our market outlook. What we've done since then is PO (23:19) is kind of standard, final, ordinary dividend. So, you see quite a difference in terms of payout ratios, if that's what you're looking at.

Our dividend policy is for an interim and final order dividend that we do at the same level every year. And then specials, we typically consider them outside the winter season. So, it's typically a November board consideration. The only thing that drives the difference in that is if we're not quite so sure if what we're going to need at one month, but we were fairly confident of our outlook this year.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. And just one that we know why not pay out more at the moment when it's pretty clear that the pricing environment stays very competitive. Just looking at your own ROE numbers, there seems not to be enough earnings pressure to see the end of the price softening. And so, I would've expected, let's say, to have a bit more stronger signal on bringing the capital in line with the opportunity. That was my own thought. I also looked at the previous years. You always paid a pretty high dividend in Q4, but still paid some special in Q1. So, it's the first time since 2012 you didn't do it. So, that struck my attention here.

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. So, I think what we've been doing over the last few years is paying out more than earnings and bringing our capital down as the market has been coming off without a fairly steady state with that now, and we're pretty happy with our core book and what we're raising there throughout a more stable level in terms of capital. And as I said, we're looking at a kind of $1.35 billion to $1.4 billion level. And we were just under $1.4 billion at the end of the year, which was not to do anything else at that stage and waiting as the year unfolded what happens over winter season and carry maybe a small excess in there, but it's really not significant.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. But that means you assumed that from here on much more stable premium levels, otherwise you wouldn't need that.

A - Elaine Whelan {BIO 17002364 <GO>}

That's correct.

Q - Thomas Seidl {BIO 17755912 <GO>}

Yeah. Okay. Thank you.

Operator

Our next question is from Ben Cohen from Canaccord. Please go ahead. Your line is open.

Q - Ben Cohen {BIO 1541726 <GO>}

Oh, hi, there. I'm going to do the three questions as well, I'm afraid. Firstly, just on the energy book, if you add back the reserve releases, it looks like you had quite a high combined ratio based on this quarter and last year. I appreciate obviously the losses are lumpy. But are you kind of confident that that portfolio given where the pricing pressures is, is where you wanted to – where you wanted to be?

Secondly on the investment side, can you just comment on the increase in the corporate bond holdings and the decline in credit quality from the AA- to A+? I think you said you weren't planning any material changes in terms of your investment portfolio, but if you could just confirm that.

And thirdly, in terms of the ROE outlook for the full year, could you just remind us in the context of Q1, which I guess was a mixed quarter, sort of where you see yourself against that goal? And do you think the market is going to allow you to achieve what you're looking to do? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Over to Paul, Elaine, and then I'll try to answer the impossible question I am afraid.

A - Paul Gregory {BIO 16314515 <GO>}

All right. So, I think it's a fair observation on the energy market at the moment, it is incredibly challenging, and it has been incredibly challenging for at least the last 12 months. I think if you look at 2015 in terms of losses into the market as a whole versus premium and how premium (27:01) across the market, trying to pretty much outstrips premiums if you will. So, in terms of how we faired last year, I'm actually very happy with how the portfolio faired. I mean, it produced $30 million of profit last year, which in any market is reasonable, and last year market is pretty impressive.

I think we mentioned about a year ago now that whenever you have an oil price environment where the dollar price of oil is low, you tend to then see a pickup in attrition and losses that just tends to happen, and that is certainly being the case over the last 12 months. That has continued into this year.

With all that said, we're pretty happy with the portfolio we've got. We are pretty much down to our core book, but it doesn't mean to say we don't get losses. Of course, we do. Energy is a volatile portfolio. It is prone to losses. I mean, in our 10-year history, we've been very fortunate to make a lot of money out of the energy portfolio and there was always going to come a time where we won't going to be able to make as much money as we have in the past. But fundamentally, the portfolio is a strong one. We do expect losses, there will be losses as there are in any class, but we are very happy with the shape of it as it sits today.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thanks.

A - Elaine Whelan {BIO 17002364 <GO>}

Hi, Ben. On your investment question, I wouldn't be anticipating any significant changes in our investment portfolio. We do always look out and try and to pick around the edges (28:38) and try and get a bit more out of it without adding any volatility. And that we're fairly happy with whatever position just now. We may add a bit more credit and I did mention we're looking at just positioning our hedge on portfolio a little bit for our overall appetite for risk asset. Asset hasn't really changed, and you will see allocations move around a little bit, around dividend timing, if you liquidate some assets, the other dividend and then it kind of builds back up again.

Q - Ben Cohen {BIO 1541726 <GO>}

Right.

A - Alexander Maloney {BIO 16314494 <GO>}

Ben, your third question, of course, I'm going to be wrong by my side. But I think, we've started – we had a good first quarter, nearly 4%. If we could do anything – if we could do double-digit this year, I'll be delighted. I'll take that now. Elaine is sort of looking at me, funny. So, I think we don't give hard guidance, but 9% to 12%. If we could do 10%, I'd be more than happy. But whatever I said it can't be wrong.

A - Elaine Whelan {BIO 17002364 <GO>}

(29:34) let me get a different outlook there.

A - Alexander Maloney {BIO 16314494 <GO>}

Yeah, we could. I'm not going to say every month in my boxer shorts (29:40). So...

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Thanks.

Operator

We'll take our next question from Nick Johnson from Numis. Please go ahead. Your line is now open.

Q - Nick Johnson {BIO 1774629 <GO>}

Hello, all. Just a question on dividend. Given the unusual makeup of investment earnings in this quarter, can you just talk through how unrealized gain treated in relation to (30:03) profit and the dividend? Do you just look at the P&L when assessing dividend, or do you also take into account the cash profit in comprehensive income? Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

It's definitely on for Elaine.

A - Elaine Whelan {BIO 17002364 <GO>}

Is that your only question? We were getting used to having three. When we are looking at dividends, we look at what we've earned on an overall basis. We focus on comprehensive income not profit before tax, and we look at our overall catastrophe (30:32). And we were kind of business that we think we want to write, and then look at how much we've got overall, and then make our dividend assessment from that. So, that's kind of all encompassing due to what we've got, and it's not a focus on profit before tax for us.

Q - Nick Johnson {BIO 1774629 <GO>}

Okay, great. Thank you.

Operator

We'll take our next question from Xinmei Wang from Morgan Stanley. Please go ahead.

Q - Xinmei Wang {BIO 17860767 <GO>}

Hi. Good afternoon. I've got two questions, follow-ups from previous questions. Firstly, on reserving and sort of reserve conservatism, it's just in the last few quarters, they have been particularly high especially when you compare it to 18 months, 24 months ago. Is that all because of a benign loss environment because I guess back 18 months, 24 months ago it wasn't that different a picture. And this is sustainable just in terms of thinking it's come from recent accident years. What it would look like if losses were brought back to normal?

And then, second on capital, on the $1.35 billion to $1.4 billion range for 2016. Is that your - I know it's your target capital level, but is that the minimum capital that you can run with if your book doesn't shrink further from here? Yeah, those are my questions. Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Yeah.

A - Elaine Whelan {BIO 17002364 <GO>}

And on reserving, I think, if you're going to go back and have a look at last year, as I said, we weren't really getting much (32:11) coming through on the two years prior to that. So it was really just a factor of releasing IBNR and nothing (32:19). We also had that recovery that I mentioned, which came through in Q1 of last year, which could have been nice to have on that. So that was a bit more than we've made, particularly, in the first season of last year.

On the capital side of things, again, it's very much driven by what exposure we've got, what cat exposure we've got, and what we want to write and what we think we can write to save the capital. And the 1.35 to 1.4 includes a buffer in there so that we're able to absorb losses and - reasonable size losses, not like super losses when they come along and then be able to go and access the market afterwards and take advantage of that (32:56) environment. If there was anything particularly significant (32:59), then we might be actually looking to go and raise capital and take advantage of (33:04) environment.

Q - Xinmei Wang {BIO 17860767 <GO>}

Okay. Great. Thanks a lot.

Operator

We'll take our next question from Olivia Brindle from Bank of America. Please go ahead.

Q - Olivia Brindle {BIO 17273762 <GO>}

Hi there. So I'm going to go back to three questions. Sorry about that. The first one, just touching on some of your comments around the top line, I'd just like to understand that a bit better because it seems like you're saying for the year you're still comfortable with having a broadly flat book. But 1Q is by far the biggest quarter in terms of premiums at 40%, give or take, and that's down 6%. So just wondering if you could explain how we're going to make that back up to be flat for the year. It seems a bit of a stretch. And a sort of related point also on top line. Just looking at Cathedral, is 14% down really in line with expectations? It seems like quite a big number. And again, that's by far the biggest quarter of the year in terms of premiums.

Second question just on the loss ratio. So you're saying, backing out mid-sized claims, you're in the sort of mid-30s as guided to. But if you exclude those mid-sized claims, it's been a very benign quarter. So actually, shouldn't you be much lower than sort of mid-30s? I would have thought, given what else has happened or rather not happened, that should be more benign.

And then, the third, I guess, more of an observation than a question, really, around the realized losses. We typically think of your business being quite conservative and not really having much investment risks and yet seeing a £9.3 million negative coming through the P&L in one quarter, it's quite a high amount. So, I mean, would you agree on that? And how do we think about that and square that with what we typically think of as a low-risk profile, I guess? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

So, obviously, I'll leave the more technical stuff to Elaine. I think on the top line stuff, Olivia, which we don't give hard – I would describe it as hard guidance, I think we're just trying to give a flavor of, so much happened in 2015. I think we're just trying to say that we believe we'll be broadly flat, whatever that means, for the year. So we're not going to sit here and give hard guidance. As you know, one thing we're definitely not is a top line company, so we can't even make some assumptions. They may move around. If you think of the Cathedral example, again, everything we talk about here is about underwriting, what's in front of you, and sometimes, that's a bit more difficult and if that means it's 14%, it's 14%.

So we believe we're down to our core portfolio pretty much across the base. There are always some timing issues around premiums. Quarterly reporting doesn't really help us in that regard. And even in today's market, we tend to write smaller number of risks, particularly Lancashire and some higher premiums, so it can jump around. But I'm pretty confident that our top line will be broadly in line with where we think it's going to be.

A - Elaine Whelan {BIO 17002364 <GO>}

And on the loss ratio, I think given where we are at the RPI-adjusted loss ratios, I'm pretty comfortable with the mid-30s target. And there has been a lot of stuff happening. We have had a couple of mid-sized energy losses, but there are also just smaller bits and pieces that happened from time to time anyway.

On the realized losses, I wouldn't say that we've changed anything in terms of our focus and philosophy around our investment portfolio, and it's still conservative as it was. And it's the key to all clear things up here now and line items we used to mark everything to market. So our change in (37:05) the hedge losses (37:09) hedge funds now that the mark-to-market to income, and we've got some other (37:11) of things about the mark-to-market to income.

As I said, the largest part of that number for this quarter is actually the mark-to-market on our hedging and our portfolio, which we think is going to give you a flavor of the conservatism we saw there. So I wouldn't expect anything to change. And the only thing that's probably new in there, which was in their last quarter is taking a little bit of impairment across some of our bank loan portfolio and a couple of energy stocks.

Q - Olivia Brindle {BIO 17273762 <GO>}

Okay. Thank you. That's helpful.

Operator

We take our next question from Frank Cawood from Frank Cawood & Associates. Please go ahead, sir. Your line is open.

Yes. And I'd like to again congratulate the whole staff on the excellence of the consistency of the way your core book is performing. And maybe just some more comments about that, because I think that's extraordinary that with lot of the companies we don't see that and (38:10) consistent with Lancashire over the years.

And then another remark as far as your maybe annualized ROE, you've to realize that we are in such a zero interest rate environment that there's a good argument that shadow interest rate is actually below zero. And in that sense, it would mean that you should probably give 2% or 3% brownie points to what your ROE is so that in a normal, even low interest rate environment, in fact, make, say, 14%, and with this zero interest rate thing 2%, 3% below that. So with that in perspective, if you've any comments on that?

And then a specific question for Elaine. And I think you may have answered that on your finance charge this year, it was up $3.3 million. And I guess that may have been from the renewal of your credit facility. So if you could comment on that, please. Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Thanks for your kind words. I think the point you make about zero yield is the way I kind of think about it. And I'm sure if it was in a much more normal period, all shareholders would've had a much bigger return from their insurance portfolios. So it's nice to hear that what we can produce for our shareholders today is acceptable. Obviously, that could change if we went back to a normalized world. But equally, we would expect to make some investment returns in that world.

So, for me, it's a relative gain. It's about taking enough insurance risk to give an acceptable return to our shareholders. One thing that you always say and the rest of our shareholders say is that they don't want us taking unnecessary risk and reaching for yield in a pretty choppy insurance environment. So that's good to hear.

So, for us, it's about doing the right job, generating a good enough yield for you guys, not doing anything too ridiculous. We would love to take more insurance risk, we've always said that. We're only going to do that when the market is there. We'd love to provide a bigger return. But until that day comes, we're more than comfortable just producing what we need to, to provide the yield to keep you guys happy. Core book, P.G.?

A - Paul Gregory {BIO 16314515 <GO>}

Yeah. Hi, Frank. Yeah, I mean, something we've been very pleased about across the Group over the last year or so, really, is how we have been able to defend that core portfolio. And to be honest, it's that core portfolio that (40:51) that we've been able to generate relatively respectable combined ratios through that period. I mean, we haven't really seen any loss of that core book. And in every line of business, we've maintained our relevance. And in a number of instances, in many large - or actually - and as I mentioned earlier on the call, Japan is a great example of that, we've actually been able to expand our participation with certain core clients, which when better returns return, will obviously bode well.

A - Elaine Whelan {BIO 17002364 <GO>}

Hi, Frank. I'll just pick up on the finance charge. Our standard kind of debt cost and other bits and pieces in there runs to about $4 million every quarter. The uptick this time around is the mark-to-market on the interest rate swaps that we've got. We've got a swap on the original Lancashire debt. And there's a little bit in there for - as you said, in the renewal of our credit facility. It expired in April, so we have to go ahead and renew that. And it's $1 million that's in there, but that's kind of a one-off cost for this year.

Q - Operator

Okay. Well, thanks, Elaine. That makes sense. That's just something minor. So I appreciate that.

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. You're welcome, Frank.

Operator

Our next question is from Thomas Fossard from HSBC. Please go ahead. Your line is open.

Q - Thomas Fossard {BIO 1941215 <GO>}

Yes. Good afternoon, everyone. I've got three questions. Maybe you - first question for Alex and Paul. I would be interested in getting your views on the overall reserve situation of the market. Is it something you're looking at and you're starting to see some weaknesses around? I know that you're more on the short-term side and the market is probably more on the long-term side, again, on a relative basis. But any sense of how you're reading the market on that front will be quite interesting to get.

The second question will be on Cathedral management. Obviously, we had some big headlines over the past weeks, months. Could you somewhat reassure us that, obviously, the people who wanted to leave probably post the retention plan have now gone and will be freed from any additional headlines coming from that front?

And the third question will be, we are now in a pretty, I would say, not stable environment, but a situation where you're fighting with the environment, focusing on your core book. Is this some softening of the prices? Are there any high-level strategic thinking maybe in trying new business lines or adding things in your book that you're not doing, obviously, with a usual credence you're having on the underwriting side and doing that with the right people?

But, I mean, are we at a point where, unfortunately, there is nothing you can do much with the type of business you've been historically writing and that at the end of the day, strategically, you're thinking in doing things a bit more differently than in the past? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Right. Okay, Thomas. So, I think, question one, I'll have a stab at. I'm definitely not a casualty expert and that's not in our bag. I think what's interesting if you look at some of the things that have happened recently with some of the larger companies, I think there's clearly – I mean, (45:00) casualty business. It's very easy for some of those people to move their numbers around. And there's been some reserve strengthening from some of the carriers out there. I think (45:10) described it as a sort of cheating phase.

So, usually, if you look back in history, I'm a sort of insurance historian, I believe that nothing is going to be different this time around, and that usually is a fair signal that maybe the game is up. So I don't really know. I think for me it's quite interesting. It's very interesting when you see things like that happening. So that, I think, is a reasonable sign that there's not much left in the tank for some of those companies.

My general feeling on that is for me, it kind of feels like the year 2000. So, for anyone who is kind of around then, the late 1990s was horrific. In the year 2000, things started to creak a little. And I think there was a general realization that we were kind of bumping around the bottom of the market. It kind of feels like that to me today. That's not to say anything dramatic is going to change. But what I do believe is that there's not a lot of dollars left in the system. And if you just look at the 2015 results for the whole industry, they're not that great, bearing in mind nothing happened. So I think it could go from looking vaguely okay or vaguely acceptable versus a zero-yield environment to something that looks quite bad quite quickly if you had a certain run of events. So that'll be interesting to see what happens then.

I think on the – I'll talk about the Cathedral thing, and I'll let Paul talk about new business sides and how we think about that. I think on the Cathedral side, obviously, we've been in the press a lot. We've had some departures. I think there's a number of things there. I think if you step back and if you look the – if you just think about it as any acquisition and a sort of natural development of when a company buys another company, there were certain incentives that matured at the end of January, and there was – I think what I'm trying to say is I think it's was putting the inevitable that we're going to lose some people at that stage. I believe that's all happened now. I don't believe we're going to lose any other people. Obviously, I don't know for sure, but I believe that the people that are here now are committed to the Group and actually see it as an opportunity. And we need the people at Cathedral to step up, and that's what they've done.

Richard Williams has taken over as active underwriter. That's exactly what I needed to happen, continuity of that business because Cathedral is a good business, there's nothing wrong with that business. The last thing I want to do is change anything about that business. If anything, we want to do more business in Lloyd's, and we need the people at Cathedral to do that for us. And we constantly think about different product lines. Paul can give you a bit more flavor on it. But actually, this period of change has opened the door for a number of conversations.

So it's been quite a fascinating time, albeit we've had too much going on. I'm more than happy to go back to a period of calm. But it's been quite interesting and, as I said, it's been fascinating in some of the conversations we have had. Because, as you know, in our industry, there's a lot going on. There's a huge amount going on with M&A. And we've a number of individuals that don't actually see working for a massive organization that may even do more M&A is a great opportunity for them. And one of the things that we are so clear about here is that particularly for underwriters, if you come to work at this shop, you can still be an underwriter, and that seems quite a novel concept at the moment in the current market, and actually good underwriters want to do that, and that's what we can offer them.

So I'm confident we can have more conversations. Whether we get some of those across the line or not, we'll have to wait and see. It's always very difficult getting the best people because there is not that many people in our world. But I do think we have things to offer that others can't. Would you want to give any more color about product lines?

A - Paul Gregory {BIO 16314515 <GO>}

Yeah. I think I'd just say that as we've said pretty much over the last couple of years, we're always open to conversations with people. We're always going to be focused on short tail, primarily. And there are lines of business that we're not currently in. I think, as Alex alluded to earlier in the call in answer to another question, (49:35) we probably should have done a bit more than we have. We are going to be focused on getting people in, assuming they're the right people and assuming that we think, in time, that those lines of business can make money. I think in any line of business at the moment, anything is going to be marginal. But if you can get the right people, you can still make money and then have the right team in place when there is a better opportunity in the future.

And one of the pleasing things over the past few weeks and months was, obviously, following a number of departures in the Cathedral business, there was a lot of interest in joining the Lancashire Group. So, we clearly accompany the underwriters who want to work for, which is great.

And then, we just need to make more progress over the coming year in terms of getting people in. And people can come into any part of the business. It's a beauty of having a free platform, which Alex mentioned earlier. Some business is better suited to Lloyd's; some is better suited to company market; and some might fit within Kinesis, it doesn't really matter to us. It's just about getting the right people in. So that hasn't changed. We're going to push harder to make sure we get some more people in over the next 12 months to 18 months.

Q - Thomas Fossard {BIO 1941215 <GO>}

Thank you, guys.

Operator

Thank you. This confirms that there are no further questions in the queue now at this time. So I'm going to turn the call back to Mr. Jonny Creagh-Coen, Head of Investor Relations, to take any questions via webcast. Thank you.

A - Jonny Creagh-Coen {BIO 16117271 <GO>}

As we have no further questions, thank you, everybody, for coming to call today. And we look forward to the next quarter.

Operator

Thank you. Ladies and gentlemen, this now confirms the conclusion of today's conference call. Thank you for your participation. You may now disconnect.