Q3 2014 Earnings Call

Company Participants

- Alexander Maloney, Chief Executive Officer & Executive Director
- Elaine Whelan, Group Chief Financial Officer & Executive Director
- Paul Gregory, Group Chief Underwriting Officer
- Peter David Scales, Chief Executive Officer & Director
- Richard Williams, Underwriter - Aviation

Other Participants

- Andy D. Broadfield, Analyst
- Anthony Araujo Da-Costa, Analyst
- Ben Cohen, Analyst
- Janet C. van den Berg, Analyst
- Jonny Peter Urwin, Analyst
- Kamran Hossain, Analyst
- Olivia S. Brindle, Analyst
- Thomas Fossard, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by. Good afternoon and welcome to the Lancashire Holdings Q3 2014 Results Conference Call. Throughout the call, all participants will be in a listen-only mode and afterwards there will be a question-and-answer session. Just to remind you, this conference call is being recorded.

Today I'm pleased to present Alex Maloney. Please begin your meeting. Thank you.

Alexander Maloney {BIO 16314494 <GO>}

Hi. Good morning, ladies and gents. We have a number of people on the call today. We have myself; we have Elaine Whelan, our Group CFO; Paul Gregory, our group CUO. We have Darren Redhead, who is the CEO of Kinesis. We also have in London, Peter Scales, John Hamblin and Richard Williams from the Cathedral side. And, obviously, everyone is available to answer any questions.

I'm happy to report we grew fully converted book value per share by 1.6% for the third quarter with an acceptable combined ratio of 82.4 and 74.5 for the year-to-date. These third quarter results have been impacted by a couple of losses that are within management expectations, but, obviously, when looking at a single quarter, can distort the quality of the underwriting portfolio.

We are a company which focuses on maximizing our ROE across the cycle, and we clearly do that, so we will accept the odd lumpy quarter. We have and will continue to be more candid than most about the current environment which we trade in. It's fair to say this market is the most difficult we have seen since the formation of Lancashire, but it's not the most difficult many of us have seen before.

We still believe in the cycle and we do not believe this is a new normal, albeit we will need to see a large amount of capital retract from the market for the market to turn. No one can predict what will change the current environment, but history suggests that eventually events force capital providers to demand higher returns.

We believe that getting distracted away from your core business and customers in the current environment could be very dangerous. You will not see Lancashire entering new lines of business or writing new products unless we are 100% convinced we have the right personnel and understand the business.

Our commitment to underwriting the cycle has meant that our risk levels have reduced in line with our view of the market. This has allowed us to pay a large special dividend, which demonstrates our commitment to only deploy capital if we think it's in the best interest of our shareholders.

The market is changing, but companies with the right people, core business and sensible strategic plans will weather the storm. Others getting distracted or companies with over-optimistic plans will find it very difficult.

And I'll now pass over to Paul Gregory.

Paul Gregory {BIO 16314515 <GO>}

Thanks, Alex. We've spoken often about the importance of nimbleness. In today's rapidly changing market, nimbleness remains as important as ever. Historically, we've reacted swiftly to market changes by entering, exiting, growing and shrinking in markets in accordance with the opportunities, or lack thereof. This is a part of the Lancashire DNA and still remains the case today.

Over the past few years, we've redeployed capital away from D&F and retro to build out our core Lancashire property cat portfolio, and this build out was effectively completed earlier this year. We're now at the stage of strategically managing this portfolio and, as pricing terms and conditions weaken, we will carefully underwrite through the cycle, as we've always done.

This is evidenced by a reduction in premium for both property cat and retro in Q3, as we looked to optimize the book of business and stay true to our selective underwriting approach. As (3:49) insurance lines for many years, we now have a strong core book of reinsurance business across the group that is ours to defend and mold as we see fit, dependent upon market conditions.

In this market, having a portfolio of business puts you in a far stronger position than that of someone trying to gain market share. Where we've been increasingly nimble in recent times is with our outwards purchasing. We've always said in that in hard markets we're willing to take more risk on the balance sheet, and when markets soften, we'll take less. That's exactly what we have done and will continue to do.

This does not mean that we compromise our underwriting standards on the front end, but simply manage our volatility in a market where opportunities are less plentiful and (4:32) opportunities are a shorter duration. We are just underwriting the market we see in front of us, which is exactly what we've been doing since our inception.

Reduced portfolio volatility along with a market not particularly awash with exciting underwriting opportunities allows us to review our capital requirements, as can been seen from the special dividend declared today. Although the quarter has been relatively free of headline losses, for us, it has been more attritional quarter than normal, with nothing of any real significance other than a satellite loss of circa $14 million combined for the group.

It is always worth remembering that our business still remains specialty insurance focused. And in these sectors, you can have lumpy quarters. And this was one of them. That said, a year-to-date combined ratio of 74.5% more than demonstrates the quality of our underlying portfolio and is a testament to the efforts of our underwriting team across the group.

Expectations for 1/1 (5:29) are for continued softening in the majority of our lines, with some additional pressure on terms and conditions in the reinsurance classes. Our established position as a leader with a high quality portfolio of business does not insulate us entirely from the vagaries of the market, but does put us in a better position than most to navigate through the softening cycle.

As we said before, we're now a bigger buyer of reinsurance than we've ever been, so a soft reinsurance market brings with it many positives for us. It allows us to better protect the balance sheet and defend the quality core of book of business we're fortunate enough to have. In our buying of non-marine retro, we're utilizing the expertise within the group, with Mark Wilson of Cathedral now spearheading this purchase.

The build-out of Syndicate 3010 continues to progress well. Our aviation teams, led by Bruce Carman and John Spence, are now fully up and running and in the midst of aviation renewal season as we speak. We're well placed to take advantage of the aviation war opportunities. And even if these are not quite reaching the levels we'd hoped for in the immediate aftermath of the losses, it's still a significantly better market than when we took the decision to enter the class.

Darren and his team have continued the excellent progress with Kinesis. Kinesis now has an established set of investors and clients, which is a strong set of foundations to build from. And Kinesis will look to deploy more limits at 1/1 (6:50) if the underwriting opportunities exist.

At this point in time, the outlook is positive, as both existing and new clients see the benefits of the Kinesis product, signaling increased demand. As always with Lancashire, the viability of the underwriting opportunity will determine the course of action.

I'll now pass over to Elaine.

Elaine Whelan {BIO 17002364 <GO>}

Thanks, Paul. Hi, everyone. Our results are on our website, as usual. We produced an ROE for the quarter of 1.6%, bringing us to 8.1% for the year-to-date. With had a small loss recorded this quarter before acquisition adjustments, Cathedral have now contributed 0.8% to the group's ROE for the year-to-date. Warrant exercises for the year-to-date have reduced ROE by 0.7%.

To save any confusion, I think it's worth reminding you that last year's Q3 results reflected the equity issuance and foreign exchange transaction we had entered into as part of our agreement to buy Cathedral. Together they added about 6% to ROE.

In terms of premiums, again, most of our increase in the quarter comes from Cathedral. We added $50.3 million of premiums from them this quarter. While the pre-acquisition lines were behind last year, that reduction was almost entirely offset by new premiums written in the energy and terror lines that Cathedral now writes and also by additional income of the new the aviation team. Those lines are all written in Syndicate 3010.

For Lancashire London and Bermuda, property premiums are behind last year, mostly due to the impact of long-term contracts which are not due to renew. Also, as Paul mentioned, we continue to see worsening terms and conditions in pricing and property cat deals and, as a result, some deals were not renewed. While there is some movement within energy sub-classes, the energy portfolio overall was pretty flat compared to Q3 2013.

For the fourth quarter, for Lancashire's book, we will likely continue to see some reductions. The same is true for Cathedral, although we should continue to see growth in the new terror, energy, and aviation lines. As in prior years, we don't give top-line guidance. But bear in mind, we had a number of multi-year deals in 2014.

Ignoring lines that are generally non-annual across our property cat and energy lines, we had about $150 million (9:03) of premium from multi-year deals. While we'll have the benefit of those earning out over the next year or two, you'll see a notable reduction in our gross written premiums in 2015. That will be offset by some new business we expect and also further growth in the new lines of business in Syndicate 3010, but our top line will be significantly lower than 2014.

The impact on net premiums earned will be substantially less, given the earn-out of the multi-year deals from 2014. Our net loss ratio was 44.8%. As Paul said, while there have been no major events this quarter, there were a number of smaller losses that had an impact. With net releases in prior years of $11.3 million for the quarter, our accident year ratio was 50.1%. That's obviously higher than we had expected our attrition to run up, but there have been a few smaller headline events which impacted our results for the quarter. We don't comment on individual claims, but I think you all will have seen announcements in the press about the recent aviation losses.

With Cathedral's strong presence in the aviation market, that's obviously an area where they picked up some losses, although we also avoided some, too. Cathedral also had some exposure to Hurricane Odile in Mexico. As for Lancashire, we had some exposure to the recent satellite loss that was reported, plus a few million here and there on very small cat events over the quarter.

Attrition in the quarter is not indicative of an increase in our expectations for loss ratios. Our business is lumpy and individual quarters are not representative of the book. Where Lancashire was previously in the low 20%s, we had indicated at the beginning of this year that that increased to the mid-20%s with the softening market. The addition of Cathedral, with a less volatile but typically lower cat stream property portfolio, increases our attrition to the low 30%s.

Hopefully that makes it a little bit clearer. Bearing in mind that these are estimates and the quarters will vary depending on what's going on in the world. As Alex said, individual quarters are not a reliable guide to the overall trend.

On investments, including FX hedging impacts, the portfolio was flat for the quarter as it was impacted by treasury yields increasing and credit spreads widening. There's been no real change in our investment strategy, although we've adjusted our asset allocation slightly. As much as in the underwriting side of the business we try not to take a quarterly view of our investment portfolio, but rather structure it for the longer term, just making tactical adjustments around the edges. We've been increasing our duration a little and are happy now around the 1.5-year mark.

As I mentioned last quarter, we've allocated just under $100 million to a low volatility hedge fund portfolio. We may add a little more to that later on this year or early next. The goal there is not to go crazy with the risk assets in our portfolio, but really to diversify and help in managing our exposure to interest rates in advance of the Fed hiking rates. We've also increased our floating rate product a little and continue to hedge our interest rate exposure. The hedge fund portfolio has returned 0.3% for the quarter and 1.4% for the year-to-date.

On KCM and capital deployed, to-date we've earned about $6.2 million in underwriting fees this year. As I've mentioned previously, we do earn those fees in line with the underlying exposure in Kinesis Re's portfolio. Most of the exposure is over a year's hurricane season, so the bulk of the fees for the year are earned now, with $2.9 million included in other income for the quarter and $4.3 million for the year-to-date.

The earning pattern by quarter this year has been 10% in Q1, 12% in Q2, 47% in Q3 and 31% in Q4. Just bear in mind that depending how the portfolio renews, those percentages might change a bit next year. We expect to recognize some profit commission in the first quarter of 2015. Depending on loss activity between now and the end of the year, we could earn up to $5.8 million. KCMs expenses are reflected within Lancashire's other operating expenses. The remaining other income is management agency fees and profit commissions from Cathedral.

Our G&A includes $8.1 million of Cathedral costs and our final amortization charge in relation to the finite life intangible assets from the acquisition. We've booked about $1.5 million for that this quarter. We've been buying back a small amount of shares, given the overall market has been trading down and there have been pockets of volatility. The aim there is not really so much about any size of capital return, but more about building our treasury shares for stock comp exercises that we know are coming further down the line.

Lastly, as you no doubt saw in our press release, we're declaring a special dividend of around $250 million in total. In 2012 and 2013, we had reasons to hold some extra capital in the fourth quarter: potential impacts of Sandy in 2012 and our integration of Cathedral in 2013. This year we're pretty confident in our market outlook and see no reason to hold back any capital that we don't need. I would anticipate our capital requirement for next year to be around $1.5 billion of tangible capital, if nothing else in the market changes.

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

Q&A

Operator

Thank you. The first question comes from Andy Broadfield from Barclays. Please go ahead.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Hi there. Good afternoon. Two questions, please. One, just on the capital side of things. I think you've just indicated $1.5 billion of tangible capital is your target. What does that represent? Is that constraint a rating agency one, your economic model? That would be useful to understand. Also, just within that context, I think you said in the past that the outwards reinsurance program that you've been adapting and buying more of has had a more profound impact on your economic capital than it has potentially on your rating agency capital, so just some update on that would be useful?

And the other question is just on your ROEs. I think, from memory, your management target ROEs range between 12% and 18% for your various LTIPS or equivalent. How long does that last for? A, is that right? B, how long does that last for and when is it due to be revised? And what are your thoughts around that at the moment? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. They're all mainly for Elaine. What I would say just on the reinsurance point is that when we've done a fair bit of work this year looking at our portfolio, buying more reinsurance. That's been because we think that's the right thing to do. That's, obviously, led us to have an excess capital position, but that wasn't the only reason we've done it. So I think trying to stick to what we've always said to you guys, if we have excess capital and we don't think the market's there, we'll always give it back.

We would be delighted to keep the capital because that would mean there'd be a great opportunity. But we believe what we're doing in this current trading environment, which is very difficult, is exactly the right thing to do. And we would question others that are not being as disciplined as us, writing new products, over-opportunistic plans. I think it's a very difficult time in the market, so we're trying to stick to what we've always said to you and that's why you're seeing that size special dividend.

A - Elaine Whelan {BIO 17002364 <GO>}

Hi, Andy. In terms of capital, we look at capital a number of different ways. We look at it for regulatory purposes; economic purposes, rating agency purposes. Our biggest capital driver will change over time depending what's going on. At the moment, the rating agencies are bigger capital drivers than anything else in our business. So that's how we derive our capital requirements at the moment.

In terms of reinsurance buying, it's nice to buy reinsurance that helps in the capital models and rating agency models. But I think our first focus in on an economic basis, making sure that we're buying the right reinsurance cover for our business.

And on the RSS awards, the LTIP stuff, that's pretty much all done that. That was way back when we first started. 2008 was when we started the RSS program. And there there's a combination of ROE targets and TSR targets on those. So the ROR made every year. It's a three-year vesting period. So they're just kind of continuing to roll off over time and there'll be new awards granted each year.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Okay. So, just to come back to that, maybe it's my confusion, the 12% to 18%, what's the existing target range for the management team?

A - Elaine Whelan {BIO 17002364 <GO>}

There are different targets for bonuses and there are different targets for the RSS, but the RSS ROE target is a range over treasury. The management target for bonus is the range that you're looking at. So that's set by rate common (18:32) on an annual basis.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Annual basis. Okay. Thanks very much. Is it fair to say that the work that you've been doing on the outwards reinsurance side has probably had a bigger effect on your economic capital than it has on your rating agency capital?

A - Elaine Whelan {BIO 17002364 <GO>}

Again, some of it impacts economic capital, some of it impacts the rating agency models.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Okay. So it's both. Okay. Thank you very much.

Operator

The next question comes from Ben Cohen from Canaccord. Please go ahead.

Q - Ben Cohen {BIO 1541726 <GO>}

Hi there. Good afternoon. I have two questions, please. The first was just to clarify Elaine's remarks about the attritional loss ratio. I took your remarks to mean that you see that loss ratio fairly stable going forward. I just wonder how that would be the case if you expect pricing to go down looking into 2015 and maybe terms and conditions worse as well?

And the second question I had was in the context of the ROE achieved for the year. Do you feel that your capital structure, with a lot of the capital sitting in Bermuda and backing the rating there, puts you at a competitive disadvantage which is going to be ever more painful, at least against your competitors at Lloyds? And is there anything from a structuring point of view that you can actually do to essentially reduce your capital requirement in this environment? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. That's Elaine, Elaine and Elaine.

A - Elaine Whelan {BIO 17002364 <GO>}

(20:10) In terms of the attritional loss ratio, we've had a number of questions from people just looking for some guidance on it. So, all we're trying to do is tell you where we think a decent kind of attritional ratio sits for our book of business at the moment. We don't really have an attritional loss target, per se. In terms of next year, then, yes, we would need to price adjust our loss ratio for any changes in pricing.

But also as terms and conditions change, we adjust our book and exposures as well, so there's an element of that that factors in, too. But the numbers that I gave you earlier are really to help you guys come up with something that's a bit more stable in your own models. In terms of our capital structure, the rating agencies do make you carry more capital than Lloyd's does, so there's a disadvantage there. There are other benefits from being based in Bermuda as well, though.

We do sit somewhere in between the U.S. monoline cat companies and the Lloyd's companies, so I don't think that where we sit in terms of capital base is inappropriate from that view. We have done quite a lot of stuff with the Cathedral guys in terms of bringing the companies together and making sure that we're taking advantage of the efficiencies.

There's undoubtedly more that we can do, and we're always looking at structure and things that we think that we can change and welcoming new ideas. At the moment, there's no major plans in the pipeline.

Q - Ben Cohen {BIO 1541726 <GO>}

And just to follow up on the capital side, has your capital requirements for Cathedral now been agreed with Lloyds, so that's essentially set for the next 12 months?

A - Elaine Whelan {BIO 17002364 <GO>}

Yes, that's done.

Q - Ben Cohen {BIO 1541726 <GO>}

Okay. Thank you.

Operator

Your next question comes from Thomas Fossard from HSBC. Please go ahead.

Q - Thomas Fossard {BIO 1941215 <GO>}

Yes, good afternoon, guys. Two questions from my side. The first question will be on the energy side for next year. How would you expect demand to evolve with falling oil prices? Do you see already, I would say, some postponing of new drilling project? And how could this negatively impact your business line next year and 2016 potentially?

And a second question. Would you be able to comment again about how you feel about your franchise and its relevance in the market? Obviously, there is a lot of talk around that in the current soft market environment with some people in the market talking of tiering and people preferring to go for big balance sheet rather than specialty players. So how do you feel in the current environment and how your relation with brokers have been so far? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay, Thomas. I'll actually answer the second one first, and then Paul will do the energy one. The relevance question is a good one. We've spoken about relevance in the past. Part of the reason we were attracted to Cathedral was that not only is it a great business with really good people, it would give us more size in the market, which undoubtedly is useful. I think that what you've got to remember, though, that if you just look at our just look at our market cap versus some of our competitors, yes, we are on the small side.

But thankfully our core clients and brokers don't always just look at that. And one thing that we've always done since the inception of Lancashire is that we've always been relevant in the markets we're in. So if you think about our business model, we're not actually in that many markets, but the markers we're in we're very relevant.

So let's just pick LNG. We're in the top five energy markets in the world. We're not a top-five market cap player, so we're kind of punching above our weight. If you think about what Cathedral have always been about, it's always been about relevance and core clients. So if you look at someone like John Hamblin's book of business at Cathedral, I'm pretty sure his clients, I mean, obviously you need an acceptable rating, but I can't see any of his clients coming to us saying unless you're a $5 billion company we can't deal with you.

So relevance is important. It's not the only thing. I think the Cathedral acquisition did make us more relevant, and even things like reinsurance. We probably did buy $50 million of reinsurance a couple of years ago. Our budget this year with Cathedral was more like $150 million. So when you're spending that money with the big brokers, that does give you the leverage factor because it is fair to say relevance is a good question at the moment. Brokers are trying to leverage everything they can. We're trying to leverage everything we can. And then even things like Kinesis, all the products that Darren's creating for brokers means they're getting commission. Obviously, we're going to leverage that as much as we can with the brokers.

So, it's a good question. It is important. It's not just about size. You've got to have the right people, the right business. But I think we're relevant in everything we do. And we won't go into anything where we're not relevant, because in this market you're just set up to fail. Unless you're relevant in the market, you will be destroyed. And I think people will find it very difficult. I'm confident that we are as relevant as you need to be for the current climate. I'll just pass over to Paul on the energy one.

Q - Thomas Fossard {BIO 1941215 <GO>}

Yeah, if I can just follow up on this one. Can you assure us that, obviously, you've seen no seepage from your start of the year position, i.e., I fully understand what you're saying. I'm more interesting to the momentum and the dynamic you may have perceived coming from your brokers.

A - Alexander Maloney {BIO 16314494 <GO>}

Yes, so an example of that would be the worst example you see in this market, which thankfully is not happening to us, is that clients or brokers just say, you're too small to even be shown the business. We are very much not in that camp. Of course, we're subject to sign-in issues and pressure on pricing, but that's just normal. But the problem you've got with some carriers out there is that they're just not big enough by themselves to even get on the panel. That's definitely not happening to us.

A - Paul Gregory {BIO 16314515 <GO>}

Okay, Thomas, I'd actually just add a couple of examples to what Alex is talking about there and then I'll come onto the oil price question, which is a very good one. This year, I mean, we've been in a softening market this year. And as Elaine mentioned in her script, we've been building out Syndicate 3010 with energy and terror, two of our biggest lines of business.

And what we're seeing there is actually clients and brokers giving us more business at the detriment of some other markets out there. So when we started that Syndicate, we had existing clients that were giving the Lancashire Group bigger shares of what we had before. So, in fact, we were getting more rather than less. So I think that's always a good indication of your relevance in a market, and we've seen some good evidence of that this year.

Coming onto the oil price question, there's no doubt that if oil prices are depressed for a prolonged period of time then this does impact demand in the energy sector. What you tend to see first are construction projects that have been scheduled getting mothballed, or put on hold for a while. Now, for us, that's actually not a particularly bad thing. Less than 5% of our energy portfolio is in the construction space. We only really participate in the construction world on high-value projects.

Now, we might see a little bit less demand there, but, as I said, in the overall portfolio it's relatively small. I think if the oil prices continue to be depressed, then I can't see values going down. But what we've seen in recent years is inflation within that sector keep up with the increasing capacity in the energy market.

Now, there continues to be increased capacity in the energy market. And if you've got a depressed oil price then your inflation factors in the industry are not going to be as strong as they were and you're going to see relatively stable limits. So it will put some pressure on. There's no doubt about that. Again, going back to Alex's point, we're a top-five energy market. We're one of the haves rather than the have-nots, so we're in a pretty good position to manage that. But a reduced oil price will have some impact on demand.

Q - Thomas Fossard {BIO 1941215 <GO>}

Okay. Thank you.

Operator

The next question comes from Frank Howard (29:05), a private investor. Please go ahead.

Hello. Congratulations on working through the soft market and what I think is a very appropriate way with your capital position. And I would just like to see if you share my point of view, that you have a lot of companies that talk about capital management and passing on new business when the market gets a little bit soft, and then you have some that actually do that. So I do not think that in any way that Lancashire's position is unfavorable compared to others because markets will harden. And the ones who have a low-risk profile when that occurs will be sitting in the cat burn (29:46) seat. So is this the Lancashire view of our managers here?

A - Alexander Maloney {BIO 16314494 <GO>}

Well, thanks for that, Frank (29:55). Yes, that's 100% our view. I think that we have always said, which sounds perfect common sense to me, that you write as much business as you can when the rates are very hard, or you accept as much exposure as you can when rates are hard. And then when you're in the softer part of the cycle, which we're now in, you obviously pull back and you wait for better times. I think we've always tried to be completely honest about what we are at Lancashire. We're an underwriting company and we are mainly doing what we think is the right underwriting things.

We would suggest that others talk the talk, but they don't walk the walk. So I think at the moment you're seeing some kind of strange activity from some other companies. From my point of view, we're trying to keep things simple here, we're trying to manage our capital as appropriately as we can. As we said in the scripts, if we can't find opportunities for capital, we're giving it back to shareholders. So I'm 100% convinced we're doing the right thing. I'm 100% convinced that, exactly as you said, the market will turn at some point, it always does. It's a supply and demand game. We do agree there's a huge capital position out there, and that may lead that sort of turn to take a longer time than what we would like.

But whoever comes through the soft cycle, exactly as you said, will be there. And that's when you can make some serious money. You just have to be patient now. You've got to be realistic about the market. You can't - as much as we think we can hold our own in the market, we can't swim against the tide. So we're trying to be realistic, we're trying to get our capital positions where we can. So, yeah, we firmly believe in that strategy.

Q - Operator

I'm going to add just one to second. Your actions here in returning a very substantial capital to the shareholders. We love that. We are not big dividend hounds, per se. But when you don't have a really outstanding use for the extra capital, I just want to commend Lancashire for really walking the talk there, so to speak.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. Thanks a lot, Frank (32:09).

Operator

Thank you. The next question comes from Kamran Hossain from RBC. Please go ahead.

Q - Kamran Hossain {BIO 17666412 <GO>}

It's Kamran Hossain from RBC. Just two quick questions. First one, it's coming back to the attritional loss ratio. Just trying to work out exactly how much the larger attritional losses were in the quarter. Is seemingly your 51.1% minus the difference between 51.1% and the mid-30%s is about the large attritional for the quarter?

And my second question is just on the aviation war market. I heard from one of the larger Europeans this morning that prices in that market are up about 200% to 300%. Is that your definition of a disappointing outcome, or were you expecting for something a little bit higher than that? Thanks.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay. So Elaine will take the first one and then we'll bring in Richard Williams from Cathedral on the aviation question.

A - Elaine Whelan {BIO 17002364 <GO>}

On the attritional loss ratio, again, there was a bit more

volume of smaller attritional losses this quarter. That happens from time to time. In the past in press releases, we've stripped out larger losses (33:37) $25 million mark. This quarter we just had a number of claims that were below that level individually, but it added up to being a little bit more meaty in terms of our accident year ratio this quarter.

A - Richard Williams {BIO 15917085 <GO>}

Hi. This is Rich Williams. Yeah, on the aviation war question, I think it's fair to say after the Malaysian Airlines loss over the Ukraine and then the events in Tripoli, there was a lot of talk about having to re-inflate the market four, five, six-fold. That over the coming weeks came down to 200%, 300%. And I think the reality is probably going to be somewhere a bit south of that.

No one's really pulled out of the market. There's still plenty of capacity and quite a lot of people trying to jump onto the business as well, so the brokers are having a bit of a field day. So there'll be more money. It'll be better rated than when we said we were going to get into it, but it's not going to be as brilliant as some people are possibly inferring.

Q - Kamran Hossain {BIO 17666412 <GO>}

Perfect. Thanks very much for the color.

A - Richard Williams {BIO 15917085 <GO>}

Okay.

Operator

The next question comes from Janet van den Berg from Morgan Stanley. Please go ahead.

Q - Janet C. van den Berg

Hi. I have just a quick question on your capital. So I was wondering whether your capital requirements have any sensitivity to the Lloyds internal model being approved or not for Solvency II?

A - Alexander Maloney {BIO 16314494 <GO>}

Okay, that's one for Elaine again.

A - Elaine Whelan {BIO 17002364 <GO>}

The short answer is no. The guys at Cathedral are obviously going through the process there. And our biggest capital driver at the moment remains the rating agencies, but we carry a higher level of capital than Lloyds' requirement anyway.

Q - Janet C. van den Berg

Okay, great. Thanks.

Operator

The next question comes from Olivia Brindle from Deutsche Bank. Please go ahead.

Q - Olivia S. Brindle {BIO 17273762 <GO>}

Hi there. I've got quite a few questions actually, if that's okay. Do some of them are quite quick. So probably the quickest one, just on the expense ratio, you mentioned and you previously said $1.5 million of amortization for Cathedral, but even if we back that out it looks like the expense ratio is a bit high. Just wondering if you could tell us if there are any other funnies in there and whether ex the $1.5 million, that's now run rate?

Secondly, going back to this point about the attritional loss ratio. You previously mentioned a roughly 34% level. And I'm just wondering if you could tell us what changes that. So if next year rates go down another 10% or 15%, how sensitive is that? Or do you think that still broadly remains at 34%? Just some thoughts on how that develops, really.

And then a third point on your satellite book. You referred fairly recently to the fact that maybe losses on that book have been higher than you expected when you went back into it. And so what's your latest thinking there? And, obviously, if you were to reduce your exposure there then that will drive the top line coming down next year as well.

And a final question, sorry, just on your ROE. You were fairly recently talking about a sort of 14%, 15% level for this year. Just wondering if you still think that's realistic. And also, is that a good benchmark for, say, 2015? Or should we expect that to deviate materially do you think? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Right, okay. We've got different questions there. I think just on that ROE point, I think that's very much at the top end what we thought we could achieve this year. So I'm not sure that's the right number on that one. On the expense ratio, Elaine will take the next one and then we'll pass to Paul on the satellite.

A - Elaine Whelan {BIO 17002364 <GO>}

Yeah. And within our G&A, there's the amortization. It was a heavier charge earlier on in the year. So there's $8.4 million in there for the year. If you adjust that back out of our year-to-date G&A ratio, you get to about 14%, which is probably a more realistic run rate.

I think if you look at Lancashire's G&A through Q3 last year and Cathedral's G&A through Q3 last year, they're both in the supplement. When you add them together they kind of pick up our fourth quarter when they were more or less fully combined and you get to something that's a reasonable run rate. There were some expenses in the last year for both parties for the transaction, but otherwise that will give you a more reasonable rate. But I think where we're trending just now is not what I'd expect to see going forward.

In terms of what changes our attritional loss ratio, in theory if pricing comes off 10% in the RPI adjusted loss ratio we will also be looking at exposure, so that we might come off a few more accounts if we don't like the pricing there. So that might stop that decline being quite as extreme as just straight price adjustment.

A - Paul Gregory {BIO 16314515 <GO>}

Hi, Olivia. It's Paul here. I think you're right on satellite. It hasn't gone quite as we'd expected, to be perfectly honest. But that does happen sometimes. If you look at the market stats for the satellite market, it's had a couple of bad years compared to its history. And we're tracking the market. As with any line of business, we'll look at it. If we don't think we can make money out of it through the cycle, then we will take appropriate action.

At this point, we have only been in it for just about two years, so there's no view on our part yet to come out of that market. But if the loss trend continues then, obviously, we're going to look at that very closely if the market doesn't adjust in accordance with those losses.

A - Elaine Whelan {BIO 17002364 <GO>}

And I just add one more thing on the G&A side of things, Olivia. I mentioned it last quarter, but it might have been missed because it was a bit of a throw-away comment. We do pick up the costs for KCM and other operating expenses, so that impacts Lancashire's G&A. So it would be trending slightly higher than it has been in the past for that. We obviously get compensated in terms of the fees for that, but it does show up in our G&A ratio.

Q - Olivia S. Brindle {BIO 17273762 <GO>}

And just on that expense point as well, the acquisition expense ratio looks a little bit high as well, so if you could just maybe touch on that as well. And just the other follow up on the ROE question for Alex. The top end of the range, is that also the case going forward, so in reality that would probably be again at the top end of what we should expect for, say, 2015? Thank you.

A - Elaine Whelan {BIO 17002364 <GO>}

In terms of the acquisition cost, I think it's probably at a reasonable run rate. I'd expect it to be around the kind of 20%, 21%, 22% level. It was a lot lower in the first quarter because we got some profit commissions in from Accordion. It does move around a bit depending on our business mix and depending what's happening with our reinsurance program as well. But I think if you stick in that range then you've got a reasonable run rate.

A - Alexander Maloney {BIO 16314494 <GO>}

On the ROE point, Olivia, I think you've just got to be realistic about the market. I think 15 points in this market would be an exceptional year for us. That is very much at the top end, I believe, of what we can achieve in the cycle. If you look what we've always stated, we have stated we can make 13% above the risk-free over the cycle. We're still way in excess of that target. So I think 15% would be a great number. I would never sit here and say that we can do that next year. We may do, we may be lucky that it might be a very benign year, but I think everything would have to go our way to get to 15% in this kind of market. So I think that's a bit high.

Q - Olivia S. Brindle {BIO 17273762 <GO>}

Okay, that's very clear. Thank you.

Operator

[Operator Instruction] The next question comes from Anthony Da-Costa from Peel Hunt. Please go ahead.

Q - Anthony Araujo Da-Costa

Hi. Just a quick question on the special div. Obviously, $1.20 was declared in this part. I was wondering what we need to think about, if there will be possibly a second special div and how we should think about this in terms of what sort of payment could be paid out at year end. And that's it. Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay, I'll let Elaine talk about numbers because she's much better at numbers than me. But the point we just want to make about the special is in the past we have done two specials, and that's mainly been to give us flexibility around the market. So what we've said in the past is when we were doing the Cathedral transaction we done to because we wanted to get that capital position as good as we could until we were completely comfortable with the numbers.

But in general, when we look at capital, we're looking at the outlook and we're looking at 2015. And where we've done to in the past it's mainly been, and we've said to you guys, we're going to do a special, we're going to see how when one goes, if there's opportunities we may use some of that capital; if not, we'll give it back. I think, to be honest, unless something really dramatic happens, we see no change to the market next year that's going to require us to need any more capital.

That's why we're doing the special in one lump. Look, something may happen. We may end up with some extra capital at some point. But at the moment, we're just looking at the opportunities we see for next year and that's why we can make a fair judgment on where we think 2015 is going to be already.

Q - Anthony Araujo Da-Costa

Perfect, thank you.

A - Elaine Whelan {BIO 17002364 <GO>}

Yes, I think that's exactly right. And I would just add onto that there's no change in our policy around our ordinary dividend. So we still intend to go ahead with the interim and final $0.05 and $0.10 dividend. As far as expectations for 2015 are concerned, it's obviously very early to make any calls on that. But if there's no change in the market, then we'd be looking at the same situation of returning either most, if not all, of earnings.

Q - Anthony Araujo Da-Costa

Fantastic. Thank you.

Operator

Thank you. The next question comes from Jonny Urwin from UBS. Please go ahead.

Q - Jonny Peter Urwin {BIO 17445508 <GO>}

Hi there. Jonny Urwin at UBS. It would be good to get a bit more color around Cathedral. I know a few of the attritional losses were coming through Cathedral this quarter. But I just wonder, since acquisition, how the attritional loss has been trending, and how should we think about that going forward? Thank you.

A - Alexander Maloney {BIO 16314494 <GO>}

Is that one for you or Pete, Elaine?

A - Elaine Whelan {BIO 17002364 <GO>}

I can start and Pete can chip in if he wants anything in there. I think it's back to the question of lumpy quarters. This quarter there was just a bit more happening in lines that Cathedral has expertise and exposure in. I think if you go back to the numbers that I was giving you for attritional loss ratios in those kind of low 30%s, that's where we see it at the moment, subject to any changes in our book.

Pete, you got anything to add?

A - Peter David Scales {BIO 15393236 <GO>}

I think the only thing we'd throw in, Elaine, is nothing that we particularly see is anything exceptional. We've got pretty low retentions. So, for instance, on the Odeal loss (45:06), we're only retaining at 100% level $7.5 million, and then so our share of that's probably $5 million. So they're quite small work-a-day things we would genuinely expect all of the time, and the quarterly reporting nature of it just highlights where some of these things appear. But in terms of actual retentions we run under the programs and the frequency of claims that drop into them, be they across many classes that we write, there's nothing exceptional. And the underlying quality underwriting is pretty good.

Q - Jonny Peter Urwin {BIO 17445508 <GO>}

Okay. Thank you.

Operator

Thank you. The next question comes from Andy Broadfield from Barclays. Please go ahead.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Hi. Thanks for the follow up. Just a very quick one on the buyback strategy. I'm just interested, you have historically for the warrants issued stock, which has been a little bit less dilutive than buying back at a premium to book and then paying the warrants at a discount to book. Is this just simply the math that worked with the choice between buying back stock or paying a special? Because I would have thought it would have been better use of that capital as a special and pay a bigger special, not that it's not huge enough as it is, and then issue the stock slightly less dilutive, but maybe I'm wrong. Can you just talk us through that?

A - Alexander Maloney {BIO 16314494 <GO>}

Sure. Just to put that in context, we spent about $12 million buying back stock so far, so it's not big bucks by any stretch of the imagination. For larger warrant holdings, we have historically issued shares and that would be our intention going forward as well. This is more for giving (46:51). I'd rather buy them back where we're trading just now than buy them back in a year's time if we're trading at 1.6 times book.

Q - Andy D. Broadfield {BIO 7273415 <GO>}

Let's hope so. Thank you.

Operator

Thank you. There appear to be no further questions. Please continue.

A - Alexander Maloney {BIO 16314494 <GO>}

Okay, thank you. See you next quarter.

Operator

Thank you, ladies and gentlemen. This does conclude today's conference call. Thank you all for attending. You may now disconnect your lines.