HISCOX

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# Highlights

## Financial

- Pre-tax profit of £70.2 million, after £165 million net loss from 2005 hurricane season
- Final dividend increased 36 per cent, making a total dividend of 7.0p per share for the year (2004: 5.0p per share)
- Strong performance from regional specialist businesses, including a profit before tax of £40.4 million from Hiscox UK and second year of profit for Hiscox Europe.

## Operational

- Hiscox Bermuda formed, financed by successful £170.0 million Rights Issue (net of expenses)
- Hiscox Bermuda and Hiscox Guernsey awarded A- (Excellent) ratings from A.M. Best in addition to existing A- (Excellent) rating for the Hiscox Insurance Company
- Strong management team in place with new appointments in Europe, UK and USA
- Successful launch of broker e-trading to complement the good growth in direct business.

## Outlook

- Hiscox Bermuda well positioned to take advantage of favourable rates
- Hiscox USA operational in 2006 with strong experienced team
- Accelerated marketing activity in 2006 to stimulate growth for Hiscox UK
- The structure of the business and its distribution channels are now both in place and working to drive the growth of the Group for the next decade.

## Group key performance indicators

| | 2005 | 2004 |
|---|---|---|
| Profit before tax (£m) | 70.2 | 89.5 |
| Group combined ratio | 96.0% | 92.6% |
| Earnings per share | 15.6p | 21.3p |
| Dividend per share | 7.00p | 5.00p |
| Shareholders' equity (£m) | 578.0 | 368.8 |
| Net unearned premiums (£m) | 361.9 | 373.1 |
| Net asset value per share | 147.7p | 125.7p |
| Return on equity | 12.8% | 20.6% |

# Who we are

A leading specialist insurer with expertise in covering a wide range of specialist personal and business risks, and offices and customers around the world.

The Hiscox ambition is to build a highly respected business, recognised for the quality of its people, products and services, and the robustness of its financial performance.

| | |
|---|---|
| Hiscox Global Markets | Reinsurance and Major Property<br>Marine and Energy<br>London Market<br>Specialty<br>Aerospace<br>Technology, Media and Telecoms |
| Hiscox UK<br>Hiscox Europe | Fine Art and Household<br>Professions and Specialty Commercial |
| Hiscox International (Bermuda, Guernsey, USA) | Reinsurance<br>Fine Art and Household<br>Kidnap and Ransom<br>Errors and Omissions<br>Inter-group Reinsurance |
| Hiscox Investment Management | Supervision of Group funds<br>Management of specialist funds for third-party investors |

# Board of Directors

## Executive Directors

Robert Ralph Scrymgeour Hiscox
*Chairman (Aged 63)*
Robert Hiscox joined the Group in 1965 and has been Chairman since 1970. He was Deputy Chairman of Lloyd's between 1993 and 1995. He is a Non Executive Director of Grainger Trust plc.

Robert Simon Childs
*Chief Underwriting Officer*
*Chief Executive Officer of Hiscox Bermuda*
*Chairman of Hiscox USA (Aged 54)*
Robert Childs joined the Hiscox Group in 1986, served as the Active Underwriter of the Hiscox Lloyd's Syndicate 33 between 1993 and 2005, and is the Group's Chief Underwriting Officer. Robert was Chairman of the Lloyd's Market Association from January 2003 to May 2005.

Bronislaw Edmund Masojada
*Chief Executive (Aged 44)*
Bronek Masojada joined the Group in 1993. From 1989 to 1993 he was employed by McKinsey and Co. He was a member of the team that advised Lloyd's during the Rowland Taskforce in 1991, and in the preparation of the first Lloyd's Business Plan in 1993. Bronek served as Chairman of the Lloyd's Underwriting Agents Association from 1998 to 2001, and is currently a Deputy Chairman of Lloyd's and immediate past President of The Insurance Institute of London. He is Non Executive Director of Ins-sure Holdings Limited.

Stuart John Bridges
*Group Finance Director (Aged 45)*
Stuart Bridges is a qualified chartered accountant, who joined the Group in 1999. He has held posts in various financial service companies in the UK and US, including Henderson Global Investors. His experience spans a broad spectrum of corporate finance ranging from mergers and acquisitions to banking, fund management and venture capital. He was a member of the Financial Reporting Council's review group on The Turnbull Guidance on Internal Control.

## Independent Non Executive Directors

Anthony Howland Jackson
*Senior Independent Director and Chairman of Remuneration and Conflicts Committees (Aged 64)*
Anthony Howland Jackson was previously Chairman of Bain Hogg plc and Deputy Chairman of Aon UK Holdings Limited. He was Chairman of The General Insurance Standards Council until 3 January 2005. He joined the Group on 8 May 1997.

Carol Franklin Engler
*Non Executive Director and Chairman of Nomination Committee (Aged 54)*
Carol Franklin Engler is the Ombudsman for the Swiss telecommunication industry and an Executive Director of the Swiss National Museum. She was the Chief Executive Officer of the World Wide Fund for Nature in Switzerland until the end of 2001. From 1979 to 1999 she was employed by Swiss Re in a variety of roles including Head of the Aviation Department and Head of Human Resources. She is currently a Non Executive Director of Citron AG and Prime Forestry Switzerland AG. She joined the Group on 12 August 1999.

Derek Nigel Donald Netherton
*Non Executive Director and Chairman of Investment Committee (Aged 61)*
Derek Netherton was previously a Director of J. Henry Schroder & Co. Limited and is currently Chairman of Greggs plc and a Non Executive Director of Next plc and St James's Place Capital plc. He was also a member of the Supervisory Board of the Schroder Exempt Property Unit Trust until February 2004 and a Non Executive Director of Plantation & General Investments plc until June 2004. He joined the Group on 6 August 1999.

Adrian Auer
*Non Executive Director and Chairman of Audit Committee (Aged 57)*
Adrian Auer was previously Group Finance Director for the RMC Group plc from 2003 to 2005. He is Chairman of Readymix plc, and his other directorships include Bespak plc, Foseco plc, Filtrona plc, and Shanks plc. He joined the Group on 1 July 2005.

Sir Mervyn Pedelty
*Non Executive Director (Aged 57)*
Sir Mervyn Pedelty was previously Executive Director and Chief Executive of The Co-operative Bank plc (from 1997 to 2004) and of Co-operative Financial Services Limited and the Co-operative Insurance Society Limited (from 2002 to 2004). He was also a Director and deputy chair of Unity Trust Bank plc (from 1997 to 2004) and a Director of the Association of British Insurers (from 2002 to 2004). He is also a former Council Member of the British Bankers' Association. His other current appointments include: Chairman of the FTSE4Good Policy Committee, a Director of Business in the Community Limited, a Director of Symphony Hall (Birmingham) Limited and a Senior Industry Adviser to Permira Advisers Limited. He joined the Group on 1 July 2005.

Secretary
Stuart John Bridges

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Tax advisors
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NE99 1PL

Bankers
Lloyds TSB Bank plc
113-116 Leadenhall Street
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Stockbrokers
UBS Limited
1 Finsbury Avenue
London EC2M 2PP

Registrars
Capita Registrars
The Registry
34 Beckenham Road
Kent BR3 4TU

# Chairman's statement

Our past investment in regional expansion has helped the Group make a very satisfactory profit despite the many catastrophes in 2005. Our new investments in Bermuda and the USA give us an even wider geographic spread, with growing books of regional specialist business to balance our internationally traded business. I am confident of further profitable growth.

## Results

The result for the year ending 31 December 2005 is a pre-tax profit of £70.2 million (2004: £89.5 million). The net assets per share increased to 147.7p per share (2004: 125.7p per share) and the earnings per share on profit after tax were 15.6p per share (2004: 21.3p per share).

The gross premium income underwritten was £1,105.0 million (2004: £1,110.9 million), of which £861.2 million (2004: £816.6 million) was applicable to Hiscox plc.

We thought that 2004 was a turbulent year, but 2005 well surpassed it with 400 catastrophic natural and man-made events officially recorded causing an estimated $83 billion of insured damage. The four hurricanes in the US and the Caribbean included Katrina, the most expensive in history. In the circumstances, a profit of £70.2 million (after a net loss of £165 million from the hurricanes) is satisfactory, and made possible by our strategy of building a book of regional specialist business (sometimes called 'retail' business) to balance the global business written in London (and Bermuda in future) that can be buffeted by catastrophes.

## Dividend

As recommended at the time of our Rights Issue, in November 2005, the final dividend, subject to shareholders' approval, will be 4.75p per share (2004: 3.5p per share) making a total distribution for the year of 7p (2004: 5p), an increase of 40 per cent on the previous year. This will be paid on 26 June 2006 to shareholders on the register on 21 April 2006. We have always had a policy of steadily increasing the dividend, but it had fallen behind the growth of the Company in recent years. With a little persuasion from our long-term institutional shareholders, we also agreed that we would target a total dividend of 9p for 2006 subject to adequate profitability and shareholders' approval.

## Corporate events

The hurricanes of 2005 stopped the slide in rates in those lines of business affected by the losses and generally stiffened the resolve of underwriters in some other areas. In order to take advantage of the improved conditions in one of our core areas, international reinsurance, we raised £170.0 million through a Rights Issue to help create Hiscox Bermuda, which was formed in time for the end of year renewal season. Bermuda is now a prime market for international reinsurance and large internationally traded business, and Hiscox Bermuda will widen the distribution of our skill in those areas. The new venture will write reinsurances of some of our specialist regional business as well as direct reinsurance to give a properly balanced account.

Robert Childs, our Chief Underwriting Officer, has moved to Bermuda which shows his and our commitment to the new venture. He will also oversee our new project to underwrite more regional business in the USA through our new operation Hiscox USA led by Ed Donnelly.

## Current business

Our Global Markets business did well to achieve a combined ratio of 99.9 per cent and a small profit considering the battering it took from the hurricanes. This was helped by the book of specialist regional business written by them which balanced, to an extent, the volatility of the reinsurance account and the big ticket London Market business. Income was steady as they were cutting back their income and exposure during 2005 in the areas where rates were falling, in line with our policy of reducing income when rates reduce and going for it when prices rise. As I said above, this all changed by the year end due to the hurricanes and they were able to take advantage of better rates during the renewal season.

Going forward, the Global Markets account written in London will be complemented by Hiscox Bermuda which will widen the spread of the account. Our reinsurance and big ticket account will always be vulnerable to extreme weather catastrophes and any run of substantial losses. This is why both in London and Bermuda, and throughout the rest of the Group, we seek to write a balancing account of specialist business.

The success story of the year was our specialist regional business in the UK which achieved a combined ratio of 84.1 per cent. We are clearly selling good products at a fair price, so to sell more and accelerate our growth we intend to increase our marketing substantially in 2006. Our European offices turned in a decent profit this year and Guernsey made its usual excellent result. Since 1989 we have spent considerable management time and money on building a regional presence throughout the UK and Europe, and now in the USA. The investment is paying off with the UK showing highly satisfactory results and Europe showing strong potential. The USA is a new venture with proven management that has succeeded in the past and I am sure will do so again.

## The market

Bermuda is the focus of much attention at the moment as it has now outgrown the London Market in reinsurance. It resembles the Lloyd's of old in its entrepreneurial spirit, speed of reaction and swift and sensible regulation. Brokers find it very user-friendly. Meanwhile Lloyd's has produced another plan to be the optimal platform and has just announced the appointment of a new Chief Executive. In 1991, in the Rowland Task Force report on Lloyd's, the worst statistic for me was that Lloyd's underwriters paid brokers higher commission than any other insurance company, but brokers made less money dealing with it than any other insurance company. Fifteen years later, after three changes of Chief Executive and much talk of optimal platforms and a fortune spent on a scrapped IT system, the same statistic probably still applies. The current Chairman has done a great job facing outwards with foreign regulators, the Government and PR, but he now needs to face inwards with his new CEO and simplify market processes and the capital structure or Lloyd's will wither away.

## The future

We have a vision of building a highly respected international specialist insurer, and we have been laying strong foundations for some time in different areas on which we can now develop strong businesses. Bermuda will give us a better spread of London Market type business. The UK regions have enormous scope for growth in their specialist areas as do the European offices. Our direct business grows healthily and will benefit from more advertising. Forty per cent of our business currently comes from the world's biggest insurance market, the USA, and we now have Hiscox USA to add a portfolio of smaller business to give balance.

## The Hiscox brand

The extra marketing and advertising in 2006 should not only give a powerful boost to our direct business which continues to grow well, but is aimed to increase awareness of our brand across all sectors of insurance we want to underwrite. In a world where insurance is often seen as a commodity which sells on price alone, we want Hiscox to be a premium brand which reflects our values of integrity and quality of product and service. Any insurer can issue a standard policy, but we want to be trusted to provide superior service around our policies – flexible underwriting giving the policyholders the cover they need rather than the cover we want to give them, flexible, rapid and fair settlement of claims and cracking good service to all who come into contact with Hiscox. We want to be chosen because we offer quality, not the cheapest price.

## People

Bronek's report shows the business in great detail, and I think it is a great credit to him and the team he has gathered round him. Bronek joined a small private Lloyd's agency in 1993 since when his dynamism, intellect and vision have led a very focused but well spread expansion in the public arena. I know it is unfashionable for a Chief Executive to spend more than a couple of years in the post, but I consider many of them just mercenaries who join with a huge signing on fee, demand a loyalty bonus to stay, and then leave with a huge pay-off when they are found to be wanting. I prefer executives (and shareholders) who feel like long-term owners of the business and want to build it well into the future. All the staff at Hiscox contribute with cheerful enthusiasm as we strive to create a great business, and I am very grateful to them. They are a pleasure to work with.

## Finally

I am sometimes embarrassed that Hiscox has been alive since 1901 and is still relatively small compared with some other new coming shooting stars. However, I think that its longevity does show a long-term dedication to the business and a will not to give up before the job is done. To use the hackneyed metaphor, we are running a marathon, not a sprint. The exciting thing is that we all feel that we have only just begun. Every day brings a new challenge, right now with new businesses in the USA and Bermuda, new offices in the UK and Europe, new technology to harness and new business processes to reduce cost, which makes it constantly interesting and invigorating. We have great people and a better spread of business than ever before, and I am confident that we are entering a new era of profitable growth.

Robert Hiscox
*Chairman*
13 March 2006

# Chief Executive's report

2005 was the year in which Hiscox demonstrated the strength of our strategy of balance. For the last decade we have been steadily building our businesses outside the Lloyd's market and have created a spread between globally traded and specialist regional risks. This meant that after the market-wide impact of Hurricanes Katrina, Rita and Wilma we were in a position to create Hiscox Bermuda, allowing us to participate in this growing market.

## Strategy

Hiscox has had a consistent vision over the past decade, to build a respected specialist insurer recognised for the quality of its people, products and service, and its strong financial performance.

In our journey we have applied the following key principles:

1. recruit and retain quality people and reward them fairly
2. maintain a clear preference for profitability over size
3. focus on specialist products backed by first-class service
4. balance the volatility of the London Market with specialist regional business
5. broaden distribution to access new markets
6. increase efficiency and reduce intermediation costs.

It is this consistent vision that has allowed us to grow steadily, moving from a single location in 1993 to 20 offices across three continents, building regional specialist businesses and growing market capitalisation from £15 million in 1993 to almost £1 billion, with the share price rising from 33p to today's level.

I believe the current shape of our business can drive the development of the Group for the next decade. We aim to build significant businesses in the UK, Europe and the USA which will focus on specialist regional risks, with local underwriters and local customer service and claims payment. Hiscox Guernsey will focus on specialist regional business for international customers. Hiscox Global Markets in London and Hiscox Bermuda will underwrite internationally traded reinsurance and big ticket business in these locations, but will use the rest of the Hiscox network for marketing and business development.

## Group performance

The pre-tax profit this year of £70.2 million (2004: £89.5 million) is equal to 15.6p per share (2004: 21.3p per share). This profit should be judged in the context of the most expensive year of natural catastrophes ever in the history of our industry.

Total revenues were £861.2 million (2004: £816.6 million). The small increase in premium reflects our disciplined underwriting in the face of declining prices in global traded risks and certain regional classes offset by increased ownership of Syndicate 33. Hurricanes Katrina, Rita and Wilma had a market-changing impact on certain classes and areas, and this will give us the opportunity to grow in 2006. The precise opportunity will vary across the different divisions within the Group. Conditions in each division's market, their past financial performance and their prospects are reviewed below.

### *Hiscox Global Markets*

This division uses the global licences and distribution network available to those who underwrite at Lloyd's to reach brokers and customers located around the world. The majority of its business is reinsurance, major property and other large international risks. The remainder is specialist business which provides the division with some balance.

Gross written premium increased to £555.2 million (2004: £511.5 million) and the division made a pre-tax profit of £20.7 million. The overwhelming financial events of the year which affected this division were the hurricanes. These cost us $730 million on a gross basis and $285 million net of reinsurance. The impact to Hiscox plc was to reduce pre-tax profit by £85 million. Our prudent purchase of reinsurance has significantly mitigated our loss, but we have very limited cover remaining for these events. This is not surprising after the biggest insured event in the history of insurance and the most expensive year of insured natural catastrophes ever.

A profitable result, albeit assisted by a significant exchange rate gain, is an outstanding achievement for a business active in this segment. Many of its competitors are on their knees. This result vindicates our strategy of building balanced businesses even at a divisional level, and reflects a great performance by the underwriting team.

The rating environment for the lines of business within Hiscox Global Markets remains robust. The hurricane season has put upward pressure on prices for reinsurance and London Market business affected by the storms. There were significant price rises on the South East Coast of America and other flood or hurricane prone coastal areas, some small rises elsewhere in the US and the UK, and very few rises and some falls elsewhere in the world. In 2006 we plan to take advantage of the higher prices while reducing our exposure in the Gulf of Mexico. In the specialist areas, business has remained profitable and significant price rises are not expected.

During 2005 our broker partners continued to restructure their businesses as they responded to the changes wrought by Elliot Spitzer, the New York Attorney General. We in turn are responding in two ways:

- first, we are establishing Hiscox Global Markets business development and marketing teams in Paris, New York and San Francisco. Underwriting expertise will remain concentrated in London. Initial indications are that this will pay off with an increased flow of attractive business
- second, we are leading the development of greater electronic trading capabilities. The demise of Kinnect, the electronic operating platform sponsored by Lloyd's, has meant that businesses like Hiscox have to decide how to reduce the cost of trading in Lloyd's themselves. Hiscox is working with five other major managing agents (a group known as G6) to do this. There have been many initiatives of this sort which have failed in the past, but we are determined to succeed.

Hiscox Global Markets remains our core business. At the end of the year Richard Watson assumed leadership of the unit. Richard has been with Hiscox for 20 years and has had experience in underwriting most classes of Hiscox business during his career. Richard's disciplined underwriting skills and leadership capability will ensure that Hiscox Global Markets adapts to the changing market environment in ways which maximise our profits within reasonable risk parameters.

### *Hiscox UK and Hiscox Europe*

These two divisions focus on selling personal and commercial products to similar customers in different countries. In personal lines both businesses aim to insure the wealthiest five per cent of the population – seeking clients who are 'rich, careful and honest'. On the commercial side, they seek to insure service-based businesses with 50 or fewer employees or 'professionally run professional firms'.

Prices in our specialist regional businesses remain attractive. Rates have reduced slightly over the past 12 months, but we believe that they are still at reasonable levels.

### *Hiscox UK*

Hiscox UK is the most mature area of business we have built outside of Lloyd's in the last decade. It had a stunning 2005. Gross written premium remained static at £207.3 million (2004: £212.1 million) with a combined ratio of 84.1 per cent (2004: 96.8 per cent) and pre-tax profits of £40.4 million (2004: £17.5 million).

The muted top line growth reflects our focus on profits over volume. In 2005 we reduced our participation in the UK solicitors' professional indemnity market – a drop of £14 million of written premiums – but this underwriting discipline will be rewarded at the bottom line. The UK business has made a greater profit than the original cost of purchasing it in 1996. We must remember the result is assisted by the absence of any significant natural catastrophes in the UK over the past 12 months. Mother Nature decided to focus on the USA and, as a Group, we have benefited from our geographic spread.

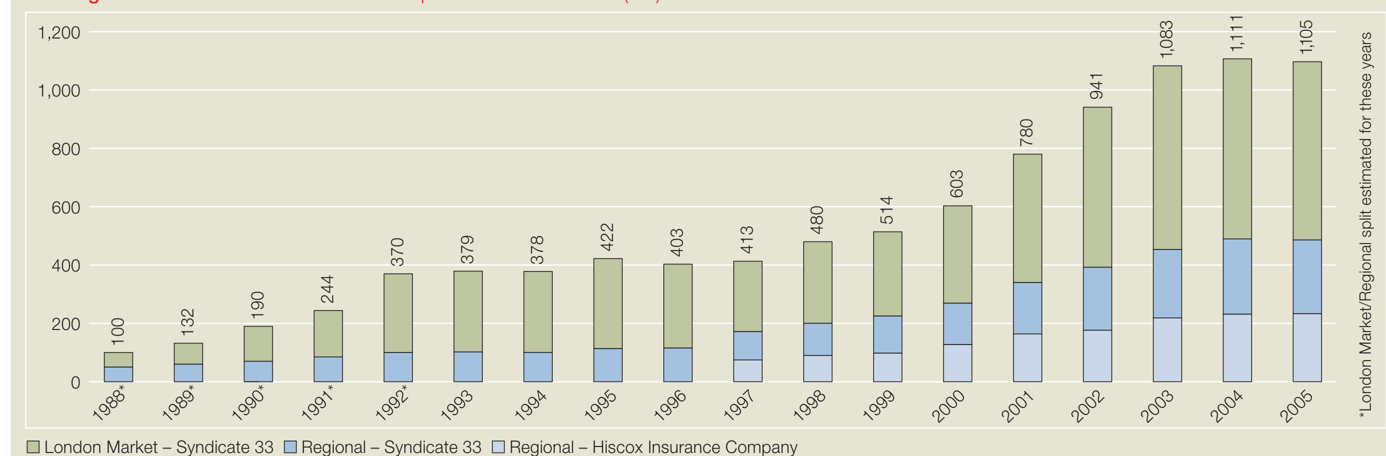
We remain a market leader in the art and private client areas and are becoming a leader in the insurance of small service-based businesses. Our business is sold overwhelmingly through brokers. In 2005 we launched an electronic platform to support both of these products with brokers. Feedback has been excellent and we expect that over time the electronic placing will allow brokers to do more business with us, lowering both their and our costs.

## Hiscox Global Markets

| | 2005 £m | 2004 £m |
|---|---|---|
| Gross premiums written | 555.2 | 511.5 |
| Net premiums earned | 428.3 | 484.0 |
| Profit before tax | 20.7 | 67.8 |
| Combined ratio | 99.9% | 90.9% |

## Hiscox UK and Hiscox Europe

| | 2005 (£m) | | 2004 (£m) | |
|---|---|---|---|---|
| | UK | Europe | UK | Europe |
| Gross premiums written | 207.3 | 55.0 | 212.1 | 55.7 |
| Net premiums earned | 194.5 | 47.1 | 170.0 | 42.4 |
| Profit before tax | 40.4 | 3.0 | 17.5 | 1.4 |
| Combined ratio | 84.1% | 99.7% | 96.8% | 103.2% |




The amounts for all periods prior to 2004 are those previously published on a UK GAAP basis, the Group's primary reporting framework at that time. The figures reported for 2004 and 2005 are prepared in accordance with IFRSs as adopted by the EU. The main differences arising on the Group's transition to IFRSs are outlined at note 3 to the financial statements.

Our direct business is making steady progress as an increasing number of clients become more comfortable purchasing their home and contents insurance and their commercial insurance over the internet and telephone. In 2006 we plan to increase our advertising to stimulate demand in both direct and brokered business.

Steve Langan became Managing Director of Hiscox UK during the year. Steve joins us from Diageo where his experience in consumer marketing and leading businesses should ensure that our efforts in building the Hiscox brand to grow the business are well rewarded.

*Hiscox Europe*

Hiscox Europe has repaid the support we have given it. It made pre-tax profits of £3.0 million (2004: £1.4 million), with a combined ratio of 99.7 per cent (2004: 103.2 per cent) and revenues of £55.0 million (2004: £55.7 million). These good results have been at the expense of top line growth as in 2005 our focus has been on improving the underwriting and reducing operational costs. Having achieved that, in 2006 we can concentrate on growth.

In May last year we employed Marc Van der Veer, an experienced Directors and Officers underwriter, to become Managing Director of this business unit. We have subsidiaries in France, Germany and the Benelux and Marc and his team will be focused on developing major businesses in these countries. We do serve other European markets in Spain, Portugal and Sweden on a small scale, managed out of London and served through partnerships with local brokers with local Hiscox representation. Over the longer term these relationships may become stepping stones for greater activity in these countries.

Our ambition is for Hiscox Europe to reach a similar scale and profit as Hiscox UK. In 2006 we will be focusing on developing a sales culture to demonstrate that the choice is not between growth and profit, but that both can be achieved in Europe.

*Hiscox International*

Hiscox International covers our offshore activities in Guernsey and Bermuda, and our nascent business in the United States. The division made a pre-tax profit of £6.2 million (2004: £2.9 million), achieved a combined ratio of 91.3 per cent (2004: 92.0 per cent) and had revenues of £43.7 million (2004: £37.3 million). All the profit in this division was made by Hiscox Guernsey as the other two businesses only commenced underwriting in 2006.

Hiscox Guernsey has been in operation for seven years. It has grown from a very small beginning, formed because particular business could no longer be written in Lloyd's, to a major financial institution in Guernsey.

Hiscox Bermuda was created in November last year and funded with the proceeds of our Rights Issue and bank debt to take advantage of the improving market conditions following the impact of the 2005 catastrophes. We had to move fast and the regulatory authorities in Bermuda, our shareholders, bankers and brokers, were very supportive for which I would like to thank them. Hiscox Bermuda is led by Robert Childs, Chief Underwriting Officer, who was previously Managing Director of Hiscox Global Markets. Robert's leadership reflects the seriousness with which we take this opportunity and the role that we feel Bermuda can play in our future. At the end of February 2006, Hiscox Bermuda had gross committed income of US$155 million of which US$46 million was to external clients and the balance reinsurance support of other Group companies. We believe we are on track to achieve the full year target of US$325 million announced at the time of the Rights Issue.

Hiscox USA is still at an early stage of its development and officially opens in March. Ed Donnelly is busy getting licences and building his team.

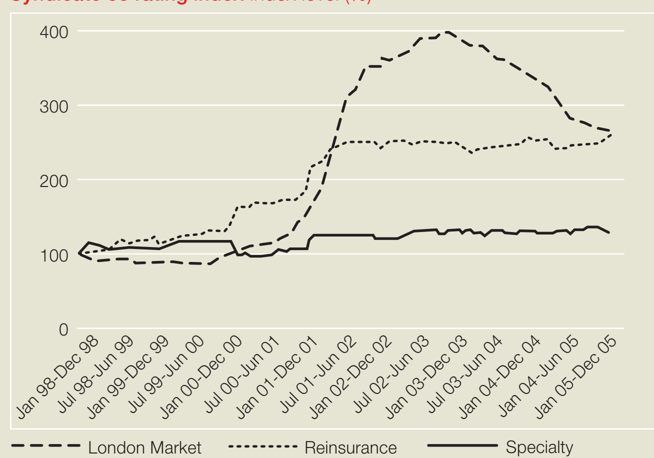
*Investment management*

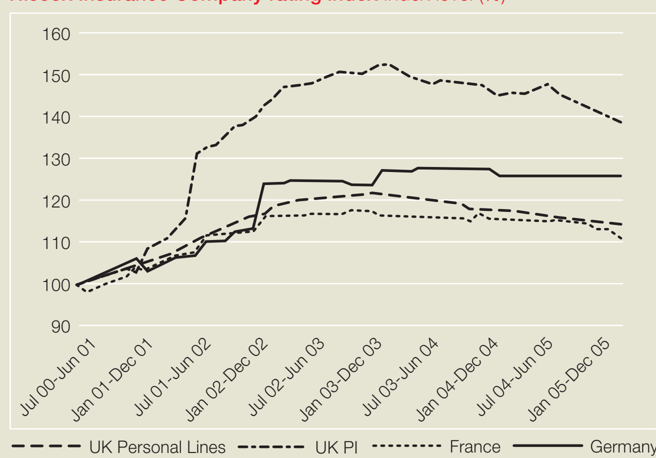
The fair value of all financial investments and cash holdings under Group management at 31 December 2005 (including the Group's share of syndicate assets) was £1,651.5 million (2004: £1,100.3 million). During 2005 these funds generated a return of £50.3 million (2004: £34.5 million).

Group investment policy concentrates on making good absolute returns for an acceptable risk. This focus on absolute returns ensures that even in poor investment years we have the necessary capital to underwrite. We ensure that this goal is reached through modelling of likely returns, backed by the judgement of our internal and external fund managers. We also have an explicit guide that the technical reserves of the Group should be invested in bonds, and no more than 50 per cent of capital to support underwriting may be invested in 'risk' assets such as equities and property. Due to the short-tail nature of the insurance risks we underwrite and the unknown loss dates, we do not attempt to match asset and liability duration. We do however remain matched in currency between our anticipated liabilities and assets.

The Group's funds are overseen by our team at Hiscox Investment Management (HIM). The HIM team supervise our external fund managers.

In addition to this supervisory role, the team also manages £165 million in six specialist funds for third-party investors. The Hiscox Insurance Portfolio, managed by Alec Foster, has performed outstandingly over the past five years. Alec remains as Managing Director and David Astor



became the Group Investment Officer during the year. Since joining Hiscox in 2002, David has run three financial funds, each of which has significantly outperformed its benchmarks since launch. The Hiscox US Financial Fund has beaten the Standard & Poor's 500 index by 55 per cent since launch in 1994.

We have had superior returns in our specialist areas which should help our ambition to grow the third party funds under management. In 2005 we launched two new funds, the Hiscox Global Financials Fund in October and the Aramus Financials Fund for Clariden Bank in Switzerland in December. These funds have already attracted over £42 million since launch.

## Balance sheet

During the course of the year net assets per share grew to 147.7p per share (2004: 125.7p per share). Tangible net assets grew to 139.3p per share (2004: 115.5p per share). The critical financing events of the year were the Rights Issue to fund Hiscox Bermuda, and the arrangement of various facilities.

In November the Rights Issue raised £170.0 million through the issue of shares at 183p per share. We received strong support from shareholders. Senior management invested net new money. It is good to receive such strong support from internal and external stakeholders. We also raised a debt facility of $225 million from a consortium of leading banks. The same syndicate also supported a refinancing of our £137.5 million letter of credit.

At the time of the Rights Issue we announced that as such a substantial amount of the Group's business could originate from the Bermudan and US markets the Board was considering a potential redomicile of the parent company to Bermuda. This work is ongoing.

The balance sheet includes a liability of £16.7 million (2004: £34.7 million) in respect of the pension fund. The investment return for 2005 on the fund was 19.4 per cent, however a decline in mortality and long bond rates late in the year increased the liabilities by 38.6 per cent. We will continue to invest well and make further contributions to reduce the deficit.

## People

It is often thought that to enter the insurance business, all that is needed is a pile of money and a bunch of people. Newcomers often underestimate the difference that quality motivated staff can make. We believe passionately in attracting, developing and retaining good people, allowing them to use their brains to make a difference – as one new employee said when comparing Hiscox with a former employer, "at Hiscox I feel that I have been hired to use my brain, not in spite of having one". The reward for creating an environment like this is a motivated team – and external recognition for the fourth consecutive year as one of The Sunday Times 100 Best Companies To Work For.

## Conclusion

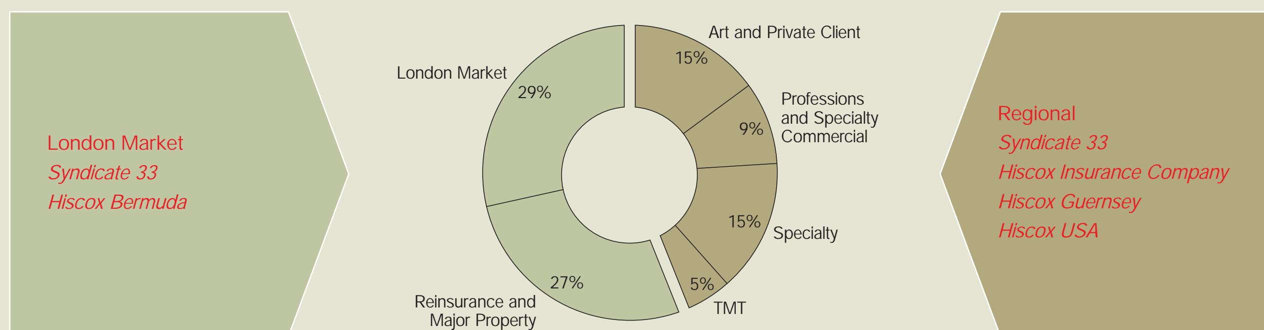
2006 is a year of challenges. Rates are at an attractive level so our ambition is to grow the business. During 2005 we created the business shape which I believe has the potential to take Hiscox forward with steady growth and profitability for Hiscox UK, Europe, Guernsey and USA, balancing the more opportunistic expansion and contraction required within Hiscox Global Markets and Hiscox Bermuda. Over time this should create substantial value for our shareholders.

Bronek Masojada
*Chief Executive*
13 March 2006

## Hiscox International

| | 2005 £m | 2004 £m |
|---|---|---|
| Gross premiums written | 43.7 | 37.3 |
| Net premiums earned | 23.4 | 18.5 |
| Profit before tax | 6.2 | 2.9 |
| Combined ratio | 91.3% | 92.0% |

Hiscox plc product split 100% = £1,105 million total group controlled income for 2005



# The Hiscox business at a glance

## Hiscox Global Markets

Hiscox Global Markets underwrites internationally traded business and other specialist business from around the world, via the Lloyd's insurance market. The Lloyd's market gives Hiscox Syndicate 33 the ability to write worldwide business using Lloyd's licences and credit rating and to source specialist business such as technology, media, kidnap and ransom through an international network of brokers.

Richard Watson
*Managing Director*

### Highlights

Gross written premium up on last year to £555.2 million. Pre-tax profit of £20.7 million despite hurricane impact.

Strong Specialty book balances volatility of London Market risks.

Appointment of new business development representatives in New York, San Francisco and Paris.

### Product split

*Reinsurance and Major Property 37%*
Key product areas: marine, non-marine and aviation reinsurance; whole account reinsurance; commercial property; onshore energy.

*Marine and Energy 12%*
Key product areas: marine hull; cargo; liability; upstream-midstream energy.

*Specialty 25%*
Key product areas: contingency; kidnap and ransom; bloodstock; small residential and commercial property; personal accident; international household.

*Technology, Media and Telecoms 5%*
Key product areas: errors and omissions; cyberliability, hacker damage and business interruption for technology, media and telecoms organisations.

*London Market 21%*
Key product areas: terrorism; professional indemnity; directors and officers; political risks; financial institutions.

### Carrier

This division uses Syndicate 33 at Lloyd's as its primary risk carrier in the London Market. Hiscox Syndicate 33 is one of the largest syndicates at Lloyd's. For the 2005 year of account the Group owned 71.1 per cent of Hiscox Syndicate 33's capacity.

### Security

Hiscox Syndicate 33 has an A (Excellent) rating from A.M. Best and uses Lloyd's security, A (Strong) from Standard & Poor's and A (Excellent) from A.M. Best.

## Hiscox UK

Hiscox UK underwrites local specialty insurance from nine different regional centres. Business is sourced mainly through local brokers. Hiscox UK has three main product streams covering:

- The personal property of wealthy individuals
- The liability and property of professional or advisory and service-led businesses
- Executive household and small professional risks marketed direct to the consumer.

Steve Langan
*Managing Director*

### Highlights

Stunning results with pre-tax profit of £40.4 million and combined ratio of 84.1 per cent.

Muted top-line growth due to reduced participation in UK solicitors' professional indemnity market.

Successful launch of broker e-trading for personal and commercial lines.

2006 will see increased advertising to stimulate growth in both brokered and direct business.

### Product split

*Art and Private Client 49%*
Key product areas: higher value homes and possessions, fine art, specie (loss or damage to valuables in transit, vault or other premises).

*Professional and Specialty Commercial 47%*
Key product areas: industry specific professional indemnity; employment practices liability; directors and officers' liability; buildings, contents and business interruption for offices.

*Direct and Partnerships 4%*
Key product areas: executive home and contents insurance.

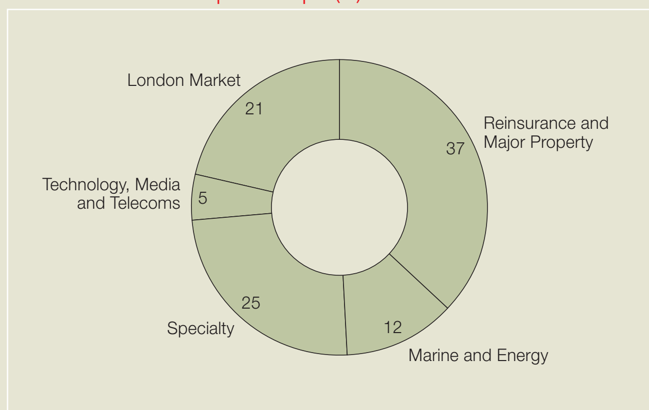
### Carrier

Hiscox UK primarily uses Hiscox Insurance Company Limited as its risk carrier.

### Security

A- (Excellent) from A.M. Best and A- (Strong) from Standard & Poor's.

### Hiscox Global Markets product split (%)




### Hiscox UK product split (%)

## Hiscox Europe

Hiscox Europe underwrites local specialty insurance from offices in Amsterdam, Brussels, Cologne, Lisbon, Madrid, Munich and Paris. This business is sourced through local brokers and has two main product streams covering:

- The personal property of wealthy individuals
- The liabilities and property of professional or advisory and service-led businesses.

Marc Van der Veer
*Managing Director*

### Highlights

Profitable for second year, with combined ratio of 99.7 per cent. Strong growth in fine art business.

New leadership team have worked on improving underwriting and reducing operational costs. 2006 will focus on profitable growth.

### Product split

*Art and Private Client 78%*
Key product areas: higher value homes and possessions, fine art.

*Professional and Specialty Commercial 22%*
Key product areas: industry specific professional indemnity; employment practices liability; directors and officers' liability; buildings, contents and business interruption for offices, contingency.

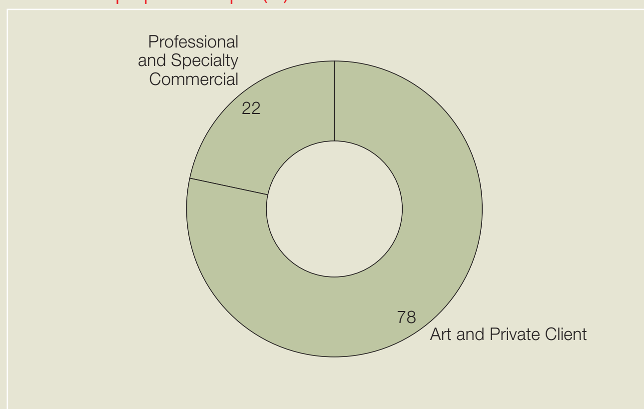
### Carrier

Hiscox Europe primarily uses the Hiscox Insurance Company Limited as its risk carrier. Hiscox Insurance Company Limited has a comprehensive set of licences allowing it to trade throughout the European Union.

### Security

A- (Excellent) from A.M. Best and A- (Strong) from Standard & Poor's.

### Hiscox Europe product split (%)




## Hiscox International

Hiscox International consists of Hiscox Guernsey, Hiscox Bermuda and Hiscox USA.

Robert Childs
*Chief Underwriting Officer*
*Chief Executive Officer of Hiscox Bermuda*
*Chairman of Hiscox USA*

Steve Camm
*Underwriting Director of Hiscox Guernsey*

### Highlights

Record pre-tax profit for Hiscox Guernsey at £7.4 million.

Bermuda well placed to take advantage of rapidly rising reinsurance rates.

Hiscox USA team formed under experienced local president, Ed Donnelly.

### Geographic split

*Hiscox Guernsey*
Hiscox Guernsey has been operating since 1998 and offers a range of products including fine art and kidnap & ransom insurance.

*Hiscox Bermuda*
Hiscox Bermuda commenced underwriting in January 2006 and will provide the Group with access to significant new volumes of reinsurance and capital to support our other underwriting business.

*Hiscox USA*
Hiscox USA opened in March 2006 and underwrites specialist business including professional indemnity, fine art, terrorism and technology, media and telecoms. The office, based in Armonk in New York State, is focused on rolling out Hiscox's specialist products for middle market USA businesses.

In addition to the Armonk office Hiscox has opened two satellite offices in Manhattan and San Francisco to develop its distribution network for larger risks.

### Carriers

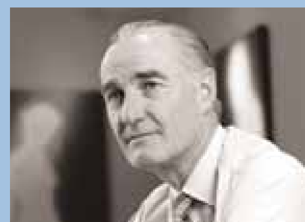
Hiscox Guernsey uses Hiscox Insurance Company (Guernsey) Limited as its primary risk carrier.

Hiscox Bermuda uses Hiscox Insurance Company (Bermuda) Limited as its risk carrier.

### Security

Both Hiscox Guernsey and Hiscox Bermuda have individual A- (Excellent) ratings from A.M. Best.

## Hiscox Investment Management



Alec Foster
*Managing Director*

Hiscox has an investment management subsidiary which is responsible for supervising the investment of Group funds which total £1.6 billion. Hiscox Investment Management also manages a number of specialist funds, in the insurance and banking sector, for third-party investors.

### Product split

Hiscox Investment Management manages six funds:

Insurance:
Hiscox Insurance Portfolio Fund.

Financials:
Hiscox US Financial Fund
Hiscox European Financial Fund
Hiscox Far Eastern Financial Fund
Hiscox Global Financials Fund
Aramus Financial Fund.

# Hiscox distribution

The Hiscox distribution network widened significantly over the last decade. Today, the Group operates from 20 different geographic locations.

This expansion outside the London Market has been concentrated on core specialty product lines where Hiscox has leading expertise. The underlying philosophy has been to start and grow organically as far as possible, complemented by small strategic acquisitions.

## Value enhancing acquisitions

The Group's overriding preference is for organic growth in core product areas. However, it will always consider opportunities with the potential to strengthen core areas or achieve other strategic objectives.

### Hiscox acquisitions

*1996*
Economic Insurance Company Limited – creating an FSA approved business platform.

*2000*
Renewal rights to Chartwell Underwriting's regional business – forming the basis of Hiscox offices in Leeds, Birmingham and Glasgow.

*2001*
Interest in Heritage Group Limited – back office services for Hiscox Insurance Company (Guernsey) Limited (subsequently sold at a profit of £2.6 million).

*2001*
Construction and General Guarantee Insurance Company Limited – Irish bond business.

*2002*
Renewal rights to XL London Market's Denham Direct professional indemnity book.

*2002*
Eldon Fund Management subsidiary of Fox-Pitt Kelton Group – adding to the fund management business of Hiscox Investment Management.

*2003*
Renewal rights to Chubb's mainland Europe household book.

*2005*
Purchase of Insurex Expo-Sure Limited – move into lower premium contingency business.

*2005*
Renewal rights to fine art business of Ascot Underwriting Limited – AIG's Lloyd's operation.

The Group's focus has been on acquisitions outside of the Lloyd's market with the potential to grow the Hiscox UK and Europe business and improve geographic distribution.

### Hiscox brokers

Hiscox trades overwhelmingly via brokers and the Group chooses these intermediaries carefully. For example brokers who apply for an agency with Hiscox UK and Global Markets must meet the following criteria:

- appropriate accreditation from the Financial Services Authority and Lloyd's
- sponsorship from a senior Hiscox underwriter who then retains a degree of responsibility for the broker
- financially stable
- similar philosophy and ethics.

Most importantly, Hiscox brokers will have a similar niche focus and understanding of specialist products. They will have high ethical and service standards when dealing with clients.

Hiscox has a positive reputation with UK brokers. An independent survey on behalf of a syndicate of insurers, co-ordinated by the British Insurance Brokers' Association in 2005 supports this. The survey of over 1,000 UK brokers provides useful information for insurers to benchmark their performance. Highlights of the results for Hiscox include:

- ranked first in the *product which meets your customers' needs* category (for both commercial and personal lines)
- ranked first in the personal lines speed of *settlement on claims* category. Achieved 4.4 out of possible 5, where average was 3.6
- equal first for *quality of underwriting* in commercial lines
- for brand perception, in personal lines, first for *acting with integrity, reliable and trustworthy and delivers on promises*
- the strongest brand identity of the companies named in the survey, especially within the personal lines market.

### Insurex Expo-Sure

In February 2005 Hiscox acquired Insurex Expo-Sure Limited, a specialist distributor of event insurance for the conference, exhibition, event and hospitality market that covers everything from large corporate events to local weddings. The acquisition is a good fit as the Global Markets division has been underwriting event and contingency insurance for over 25 years. The Group sees this as an opportunity to use its specialist knowledge in local regional markets.

## Direct

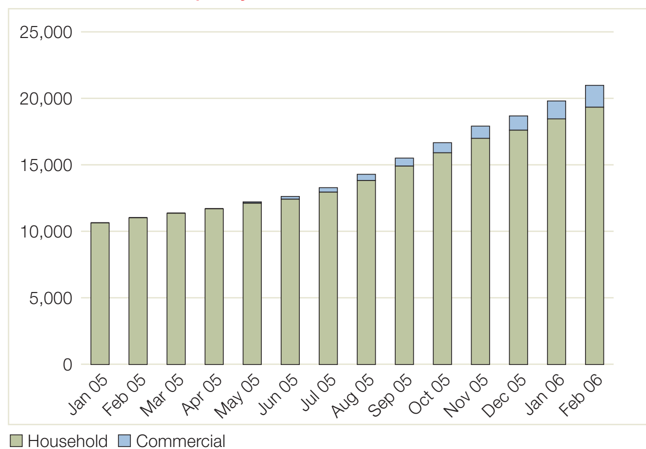
Hiscox launched executive household insurance in 2000. This product is sold directly to customers via the internet and telephone. This business has grown through developing partnerships with affinity groups, including The Law Society and the Institute of Directors, who exclusively endorse our household insurance for their members. This approach has led to more than 50 successful partnerships.

Hiscox has also formed distribution arrangements with banks such as Clydesdale, Yorkshire and HBOS to provide a solution for high value home insurance. The Direct and Partnership Division represented ten per cent of total home and contents income in 2005.

Over the last year, Hiscox UK has increased its marketing spend and tested a variety of new advertising concepts and direct mail programmes. While this activity is helping to increase awareness of the Hiscox brand, its primary purpose is to generate business for the UK operations.

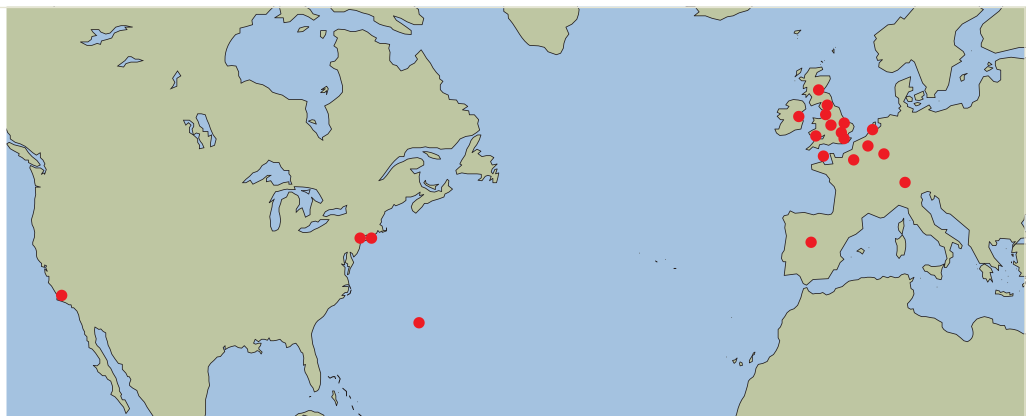
On the back of this success, Hiscox launched a direct commercial professional indemnity product to customers in 2005 that should show significant growth in 2006.

**Direct Division: Live policy count**




### Hiscox offices

| Year | Office |
|---|---|
| 1901 | London |
| 1993 | Paris |
| 1994 | Munich |
| 1998 | Harrogate (relocated to Leeds in 2001) and Guernsey |
| 1999 | Amsterdam |
| 2000 | Birmingham and Glasgow |
| 2001 | Brussels |
| 2001 | Dublin |
| 2002 | Maidenhead |
| 2003 | Colchester |
| 2004 | Madrid |
| 2005 | Tunbridge Wells |
| 2005 | Bermuda |
| 2006 | Bristol |
| 2006 | Armonk, USA |
| 2006 | New York, USA |
| 2006 | San Francisco, USA |
| 2006 | Cologne |



# The Hiscox brand and values

Hiscox has a strong brand within the UK, Europe and London broker markets. As a specialist insurer that conducts the majority of its business via intermediaries, the Hiscox name is not particularly well known among the general public. Hiscox is less well known in markets, such as the USA, where it takes advantage of the Lloyd's brand to open doors.

In 2005 Hiscox commissioned external research that formed a project to restate the unique qualities and values of the Hiscox Group. It found that the characteristics that most distinguish Hiscox from its competitors are the high quality of its people and a reputation for leadership in the marketplace due to its challenging of convention. The following core values were identified.

Integrity is the most deeply rooted Hiscox quality of all, reflected in the direct and honest way that Hiscox goes about its business.

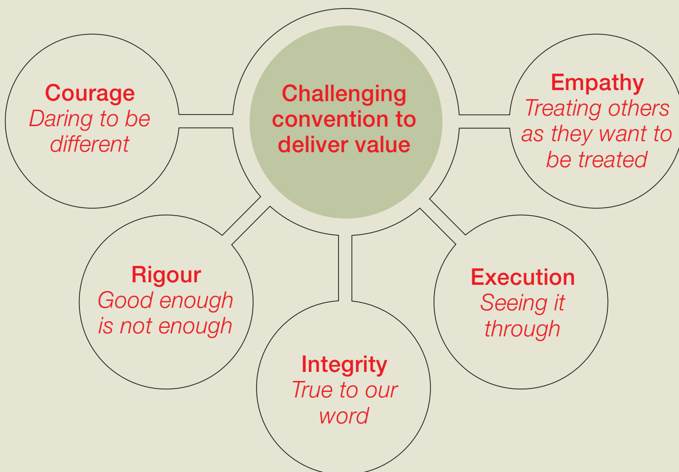
Courage is crucial for challenging received wisdom.

Rigour drives the constant pursuit of quality and efficiency.

Execution good ideas count for nothing unless you make them happen.

Empathy we never lose sight of the fact that the strength of our business ultimately relies on how well we treat our employees, partners and customers.

These core brand values are the compass that steers Hiscox internally and externally.




## Building the Hiscox brand

During 2005 Hiscox took its first steps in serious advertising to help build the brand and generate sales for the Executive Household Division. These efforts included direct mail and print advertising, and focuses on the superior claims expertise Hiscox offers.

Building on this experience and success, 2006 will see Hiscox significantly increase marketing activity, primarily in advertising the Hiscox brand among both UK consumers and the Group's UK broker operations.

This activity will be directed by Steve Langan, UK Managing Director and Head of Group Marketing, who brings over 20 years brand building experience to the Group.

# Hiscox people

In March 2006, for the fourth consecutive year, Hiscox has been recognised by The Sunday Times 100 Best Companies To Work For survey as one of the UK's best employers. This accolade aids the Group's ambition to recruit and retain high quality staff.

'At Hiscox a culture of innovation means everyone is actively involved in the future of the Company. When it was announced a new office would open in Bermuda every employee was invited to hear the Chairman and Chief Executive discuss the opportunity and answer questions. In our survey, staff said they were excited about the direction of the organisation, their 82 per cent positive score beaten by just five other firms.'

Source: The Sunday Times 5 March 2006.

## Recruitment

Hiscox seeks to attract smart, driven people to all of its positions. The Group's recruitment philosophy is based on a genuine interest in what applicants can do, not who they are or where they have come from. The recruitment process is designed to be challenging, so that applicants are stretched in ways that reflect the demanding environment in which they will work should they be successful.

## Personal development

The Group believes that there is a strong correlation between the personal growth of its staff and the growth of the business. Each employee therefore has a personal development plan, which is created annually through one to one meetings with their manager.

Staff are encouraged to continue their professional education and gain appropriate qualifications. All underwriters are required to pass the ACII examinations. Hiscox supports the professional education process by paying tuition fees and providing study leave.

Hiscox makes a further contribution to employees' professional development by providing in-house technical underwriting training. All underwriters are required to acquire an underwriting passport to show that they have a wide range of knowledge on the different parts of the Group. This is supplemented by personal impact training and management development courses.

## Recognition and reward

Advancement within Hiscox depends on the ability of the individual and the initiative they show in putting their knowledge to work.

Staff performance is evaluated annually. Performance reviews seek to allow open feedback between management and staff.

The Hiscox reward philosophy is to target base salaries and benefits at the market median, with variable personal performance and profit-linked bonuses taking rewards into the upper quartile. The Group uses external surveys to ensure that this philosophy is met in practice.

Senior staff are eligible for performance share awards and share option awards. A share save scheme is open to all staff.

## Office employee numbers at 31 January 2006

| Office | |
|---|---|
| London | 336 |
| UK – Regions | 118 |
| France | 50 |
| Germany | 50 |
| The Netherlands | 20 |
| Belgium | 9 |
| Guernsey | 7 |
| Bermuda | 5 |
| New York | 6 |
| Total | 601 |

Male:female ratio 56:44
Under 35's/over 55's 61%/4%

# Risk carriers

## Syndicate 33

Hiscox can trace its origins in the Lloyd's Market to 1901. Today, Hiscox Syndicate 33 is one of the largest composite syndicates at Lloyd's, and has an A.M. Best syndicate rating of A (Excellent).

Syndicate 33 underwrites a mixture of reinsurance, major property and energy business, as well as a range of specialty lines including contingency, technology and media risks. The business is mainly property-related short-tail business; there is little exposure to aviation or motor business.

Syndicate 33 trades through the Lloyd's worldwide licences and rating. It also benefits from the Lloyd's brand. Lloyd's has an A (excellent) rating from A.M. Best and A (strong) from Standard & Poor's. The geographical and currency split is shown below.

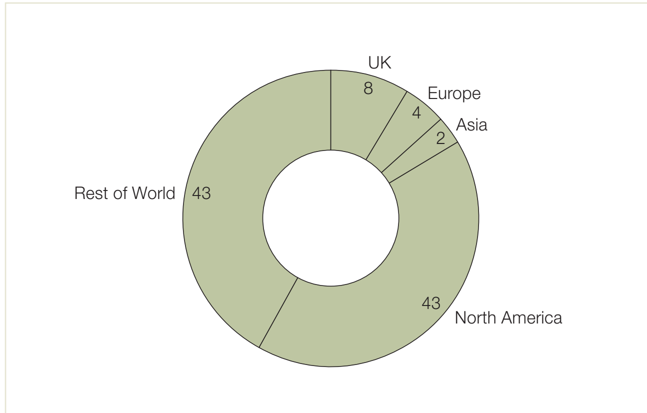
## Capital and performance

One of the main advantages of trading through Lloyd's is the considerably lower capital ratios that are available due to the diversification of business written in Syndicate 33 and in Lloyd's as a whole. Syndicate 33 has a capital requirement ratio of approximately 41 per cent of gross premium after brokers' commission for 2006.

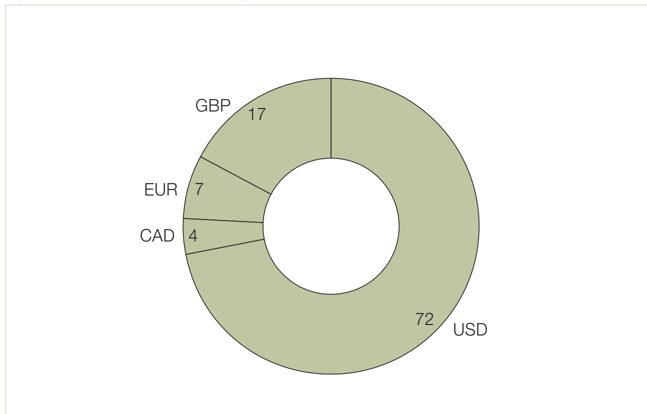
The size of the Syndicate is increased or reduced according to the strength of the insurance environment in its main classes. At present, Hiscox owns 73 per cent of the Syndicate, with 27 per cent being owned by Lloyd's Names. Hiscox receives a fee and a profit commission of approximately 17.5 per cent on the element it does not own.

The charts below show the performance of Syndicate 33 for the last six years.

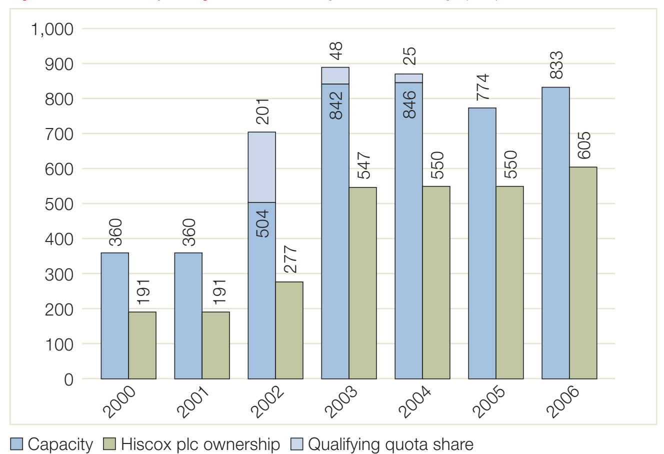
Syndicate 33 2005 geographical split (%)



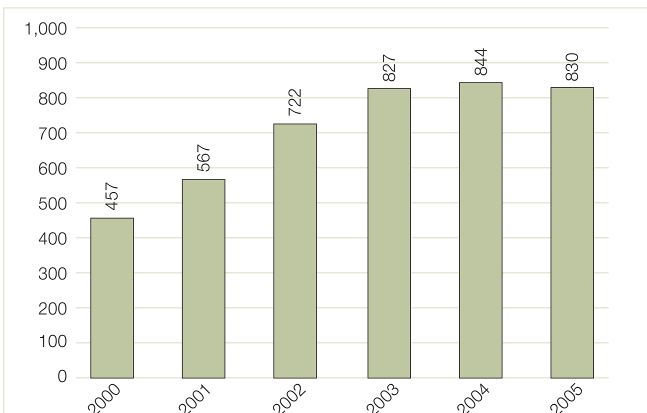

Syndicate 33 2005 currency split (%)



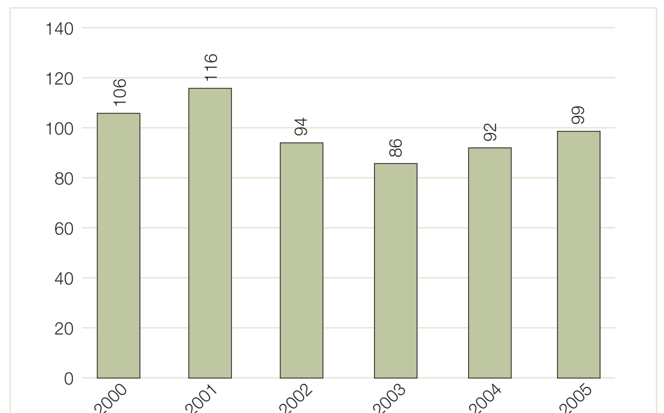

**Syndicate 33 capacity and Hiscox plc ownership** (£m)




**Syndicate 33** Gross written premium (£m)




**Syndicate 33** Combined ratio (%)




The amounts and ratios for all periods prior to 2004 are those previously published on a UK GAAP basis, the Group's primary reporting framework at that time. The figures reported for 2004 and 2005 are prepared in accordance with IFRSs as adopted by the EU. The main differences arising on the Group's transition to IFRSs are outlined at note 3 to the financial statements.

## Hiscox Insurance Company

Hiscox purchased Hiscox Insurance Company Limited in 1996. Previously known as the Economic Insurance Company, it was formed in 1901 and wrote a diversified portfolio, including general household, travel and pet insurance. In keeping with its aim of diversifying its activities outside of Lloyd's and writing a focused book of regional specialist risks, the Group has since comprehensively reshaped the portfolio to concentrate on high value household and smaller premium professional indemnity business. The Hiscox Insurance Company has licences throughout Europe. It is the primary carrier used by the UK and mainland Europe offices for their business.

The success of this strategy can be seen in the chart below. Hiscox Insurance Company Limited has achieved average compound growth in gross written premium of 15.1 per cent since its purchase, despite discontinuing almost all of its original business. It has also significantly improved its combined ratio.

Hiscox Insurance Company Limited is rated A- (Excellent) by A.M. Best and A- (Strong) by Standard & Poor's. At the end of 2005, net assets were £123.6 million.

## Hiscox Insurance Company (Guernsey)

Formed by Hiscox in 1998, Hiscox Insurance Company (Guernsey) Limited writes mainly kidnap and ransom and offshore fine art insurance. Its gross written premium and combined ratio since inception are shown in the charts below.

Hiscox Guernsey has an A- (Excellent) rating from A.M. Best.

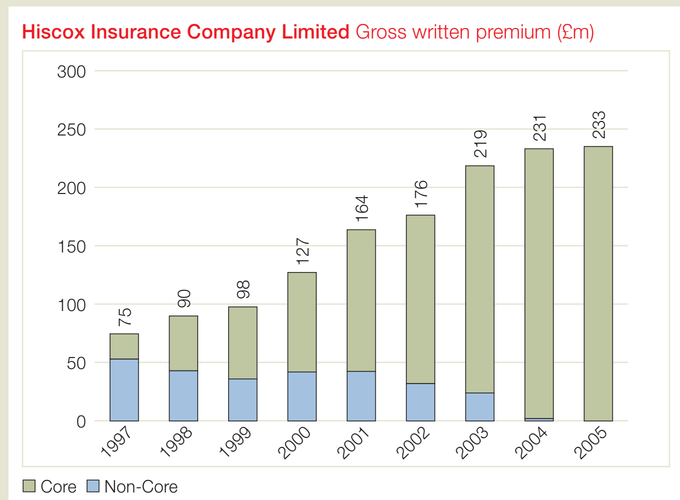
## Hiscox Insurance Company (Bermuda)

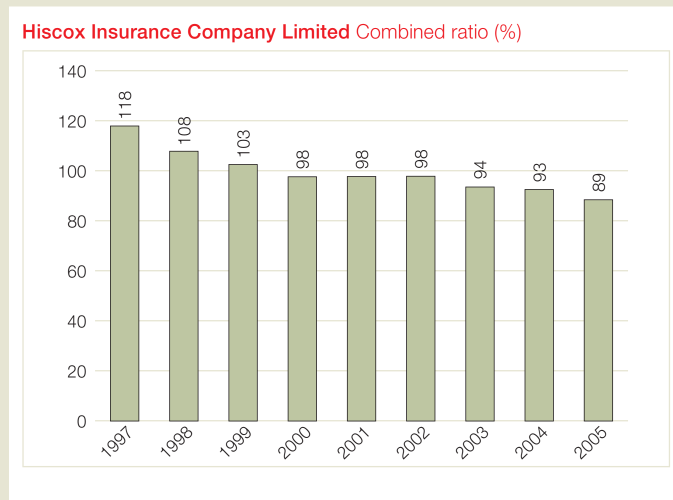
Formed by Hiscox in late 2005, Hiscox Insurance Company (Bermuda) Limited commenced writing risks in January 2006. Capitalised at US$500 million, it was formed to access reinsurance business shown to the growing Bermudan market and also to become a carrier for certain other Group income.

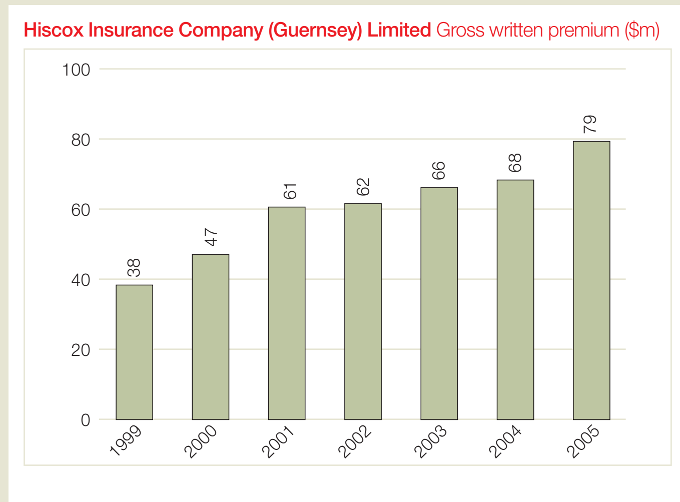
Hiscox Bermuda has an A- (Excellent) rating from A.M. Best.

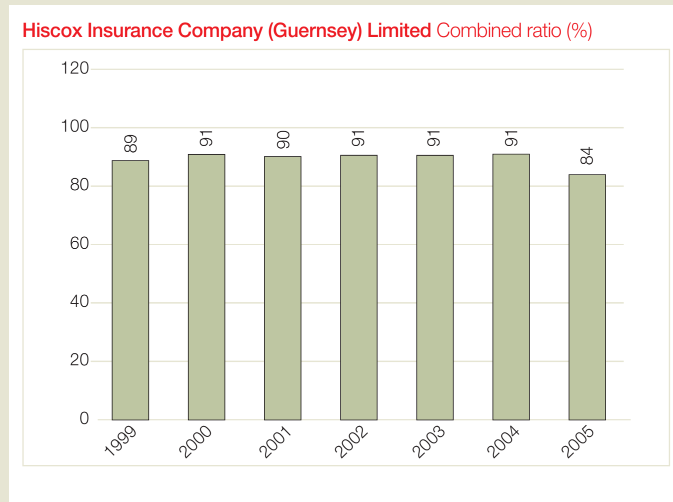
## Future carriers

Following the successful start to the Group's USA operation, the Group aims to establish surplus and admitted lines licenced carriers in the USA once the size of operation can produce a sufficient return on equity for these ventures.




The amounts and ratios for all periods prior to 2004 are those previously published on a UK GAAP basis, the Group's primary reporting framework at that time. The figures reported for 2004 and 2005 are prepared in accordance with IFRSs as adopted by the EU. The main differences arising on the Group's transition to IFRSs are outlined at note 3 to the financial statements.

# Group financial performance

The Group achieved a pre-tax profit of £70.2 million in 2005 (2004: £89.5 million). Earnings per share were 15.6p (2004: 21.3p). The post tax return on shareholders' equity was 12.8 per cent (2004: 20.6 per cent).

The underwriting performance of each reporting segment is detailed below. Total assets at 31 December 2005 grew to £2,746.9 million (2004: £1,818.4 million) and the net asset value grew to £578.0 million from £368.8 million driven by profitable contributions from each of the insurers together with £170.0 million of net proceeds from a 0.327 for 1 Rights Issue in November 2005, priced at 183p per share. At the same time as the Rights Issue, the Group increased its credit facilities by putting in place a term loan and revolving credit facility of $225 million in addition to the £137.5 million letter of credit which supports its underwriting at Lloyd's.

## Group financial performance

| | Global Markets and Corporate Centre 2005 | UK and Europe 2005 | International 2005 | Consolidated Group Total 2005 | Global Markets and Corporate Centre 2004 | UK and Europe 2004 | International 2004 | Consolidated Group Total 2004 |
|---|---|---|---|---|---|---|---|---|
| Gross premiums written (£m) | 555.2 | 262.3 | 43.7 | 861.2 | 511.5 | 267.8 | 37.3 | 816.6 |
| Net premiums written (£m) | 417.1 | 235.3 | 28.8 | 681.2 | 451.5 | 233.1 | 19.5 | 704.1 |
| Net premiums earned (£m) | 428.3 | 241.6 | 23.4 | 693.3 | 484.0 | 212.4 | 18.5 | 714.9 |
| Investment income net of expenses (£m) | 20.9 | 20.4 | 1.6 | 42.9 | 20.0 | 14.1 | 0.4 | 34.5 |
| Profit before tax (£m) | 20.7 | 43.4 | 6.1 | 70.2 | 67.8 | 18.9 | 2.8 | 89.5 |
| Claims ratio | 70.8% | 45.1% | 2.8% | 61.8% | 72.9% | 55.1% | 1.1% | 67.5% |
| Expense ratio | 29.1% | 41.8% | 88.5% | 34.2% | 18.0% | 42.9% | 90.9% | 25.1% |
| Combined ratio | 99.9% | 86.9% | 91.3% | 96.0% | 90.9% | 98.0% | 92.0% | 92.6% |

| | 2005 | 2004 |
|---|---|---|
| Financial assets and cash (£m) | 1,651.5 | 1,100.3 |
| Other assets (£m) | 1,095.4 | 718.1 |
| Total assets (£m) | 2,746.9 | 1,818.4 |
| Net assets (£m) | 578.0 | 368.8 |
| Net asset value per share (pence) | 147.7 | 125.7 |
| Adjusted number of shares in issue (000s) | 391,216 | 293,306 |

Global Markets and Corporate Centre: Hiscox plc's share of the results of Syndicate 33, excluding Syndicate 33's specie, fine art and non-US household business. It also includes the investment return and administrative costs associated with the parent company and other Group management activities.

UK and Europe: The results of Hiscox Insurance Company Limited, Hiscox plc's share of Syndicate 33's specie, fine art and non-US household business, together with the income and expenses arising from the Group's retail agency activities in the UK and in continental Europe.

International: The results of Hiscox Insurance Company (Guernsey) Limited, Hiscox Insurance Company (Bermuda) Limited, and the US agency, Hiscox Inc.

## Underwriting performance – Hiscox Global Markets

Hiscox Global Markets comprises the results of Syndicate 33, excluding Syndicate 33's specie, fine art and non-US household business.

- Gross written premium remained steady. The effects of lower rates were offset by the increased ownership of the syndicate to 71.1 per cent for the 2005 year of account (2004: 65.0 per cent) and a stronger US dollar.
- Net written premium decreased due to higher reinsurance costs, a substantial amount of which related to the reinstatement costs for the 2005 hurricanes.
- Investment income increased to £20.9 million (2004: £20.0 million), driven by increased funds under management and higher interest rates in the USA, offset by the loss on derivative contracts.
- Profit before tax fell to £20.7 million (2004: £67.8 million), mainly as a result of the worst year ever for insurance losses from natural catastrophes partly offset by net exchange gains.
- The net claims ratio decreased from 72.9 per cent to 70.8 per cent. This is predominantly the result of the significant hurricane losses being offset by foreign exchange movements arising from the application of IFRS.
- The expense ratio deteriorated to 29.1 per cent from 18.0 per cent primarily as a result of foreign exchange movements arising from the application of IFRS. For details on the calculation of the claims and expense ratios, please refer to note 5 in the notes to the financial statements.
- The combined ratio increased to 99.9 per cent (2004: 90.9 per cent).

## Hiscox UK performance

This comprises business written by the Hiscox Insurance Company in the UK and Ireland, excluding Irish surety business. It also includes the results of Syndicate 33's specie, fine art and non-US household business, together with income and expenses arising from the Group's retail agency activities in the UK.

- Gross written premium decreased by two per cent due to reduced income from the specie and eurobond binders. Having reduced the solicitors' account by £14 million, the professions and specialty commercial business remained flat.
- Net written premium remained steady.
- Investment income increased to £16.0 million (2004: £11.5 million) as interest rates remained high and equities performed well.
- Profit before tax rose to £40.4 million (2004: £17.5 million) as rating conditions remained firm and there were no major catastrophes.
- The net claims ratio decreased to 43.6 per cent (2004: 55.0 per cent); the gross claims ratio remained level.
- The expense ratio decreased to 40.5 per cent (2004: 41.8 per cent). Both internal expenses and brokerage decreased as a percentage of gross written premium despite a significantly increased marketing spend.
- The combined ratio improved to 84.1 per cent (2004: 96.8 per cent).

## Hiscox UK and Hiscox Europe

| | UK 2005 | Europe 2005 | Total 2005 | UK 2004 | Europe 2004 | Total 2004 |
|---|---|---|---|---|---|---|
| Gross premiums written (£m) | 207.3 | 55.0 | 262.3 | 212.1 | 55.7 | 267.8 |
| Net premiums written (£m) | 185.6 | 49.7 | 235.3 | 183.8 | 49.3 | 233.1 |
| Net premiums earned (£m) | 194.5 | 47.1 | 241.6 | 170.0 | 42.4 | 212.4 |
| Investment income (£m) | 16.0 | 4.4 | 20.4 | 11.5 | 2.6 | 14.1 |
| Profit before tax (£m) | 40.4 | 3.0 | 43.4 | 17.5 | 1.4 | 18.9 |
| Claims ratio | 43.6% | 51.5% | 45.1% | 55.0% | 56.7% | 55.1% |
| Expense ratio | 40.5% | 48.2% | 41.8% | 41.8% | 46.5% | 42.9% |
| Combined ratio | 84.1% | 99.7% | 86.9% | 96.8% | 103.2% | 98.0% |

# Group financial performance continued

## Hiscox Europe performance

This comprises business written in mainland Europe by Hiscox Insurance Company and the Irish surety company, together with the income and expenses arising from the Group's retail agency activities in Continental Europe.

- Gross written premium remained steady year on year. The operation in France achieved growth in gross written premium of 20 per cent. However, this was offset by a reduction in gross written premium in Germany due to the decision to discontinue certain binder business. The Group's operations in the other European countries achieved 40 per cent growth in gross written premium.
- Net written premium similarly remained flat overall.
- Investment income increased to £4.4 million (2004: £2.6 million), with improved credit control and cash management leading to higher levels of cash in the business.
- The performance of the Irish surety company continued to exceed expectations.
- Profit before tax improved to £3.0 million (2004: £1.4 million).
- The net claims ratio improved to 51.5 per cent (2004: 56.7 per cent). France had an outstanding year but this was offset to some extent by some large claims in Germany.
- The expense ratio deteriorated from 46.5 per cent to 48.2 per cent following the earnings trend of net premiums.
- The combined ratio improved to 99.7 per cent (2004: 103.2 per cent), primarily driven by a favourable loss ratio in France.

## Underwriting performance – International

International comprises the results of Hiscox Insurance Company (Guernsey) Limited (which mainly writes kidnap and ransom and offshore fine art business); in future it will include the results of Hiscox Insurance Company (Bermuda) Limited which commenced trading on 1 January 2006 and Hiscox Inc., the newly formed agency in the USA, which commenced business in March 2006.

- Gross written premium increased by 17 per cent to £43.7 million as market conditions remained firm.
- Net written premium increased by 48 per cent, driven by growth in gross written premiums and the decision to increase risk retention in Guernsey during 2005, reducing the level of reinsurance.
- Investment income increased to £1.6 million (2004: £0.4 million) as investments and cash grew to £21.3 million from £9.5 million due to the good trading and cash from the sale of shares in Heritage, an associated undertaking.
- Profit before tax more than doubled to £6.2 million (2004: £2.9 million) on the back of the trends described above, including a profit on the sale of the Heritage Group shares of £2.6 million.
- The claims ratio remained excellent at 2.8 per cent (2004: 1.1 per cent). This remains low due to the level of reinsurance purchased.
- The expense ratio improved to 88.5 per cent (2004: 90.9 per cent) mainly as a result of the increased retention in Guernsey causing net premiums earned to increase. In absolute terms administrative expenses increased by £1.8 million (2004: £0.5 million) mainly due to the set up costs of Hiscox USA.
- The combined ratio improved to 91.3 per cent from 92.0 per cent.

## Group investment performance

Bonds are the largest proportion of the Group's investments at 62.3 per cent and returned +3.1 per cent for the year. Two thirds of the bond portfolios are in US and Canadian fixed interest securities where returns were lower than in the UK. Bond portfolios in all currencies had short durations in order to protect the underlying assets against rising interest rates in the US and UK during 2005. The equities are invested for absolute returns and our weighting was 7.2 per cent. We invest in a number of pooled funds covering UK, US and global mandates and the return of +13.1 per cent reflected the spread of risk and the defensiveness of the portfolios. The cash weighting at 30.5 per cent was high at year end due to the money raised from the Rights Issue in November 2005 being held on deposit. This high weighting will fall in 2006 as the cash is invested in predominantly fixed interest securities.

## Group investment performance

| | 31 December 2005 | | | 31 December 2004 | | |
|---|---|---|---|---|---|---|
| | Asset allocation % | Return % | Return £000 | Asset allocation % | Return % | Return £000 |
| Bonds | 62.3 | 3.1 | 26,733 | 75.9 | 2.9 | 20,176 |
| Equities | 7.2 | 13.1 | 12,278 | 7.9 | 10.3 | 8,571 |
| Deposits and cash | 30.5 | 3.7 | 11,276 | 16.2 | 3.0 | 5,711 |
| Actual return | | 4.0 | 50,287 | | 3.6 | 34,458 |
| Group invested assets* | | | £1,651.5m | | | £1,100.3m |

*As at 31 December.

# Cash flow and liquidity

The primary sources of cash flow for the Group's business are insurance and reinsurance premium receipts and net investment returns. The Group is also able to access ready funds through the sale of investments.

The letter of credit and debt facilities outlined overleaf on page 30, together with the £170 million of additional funds raised through the successful Rights Issue in November 2005, have increased the Group's already considerable cash resources.

Cash outflows are used primarily to settle insurance claims, pay operating expenses and distribute dividends to shareholders.

The Group's cash flow is impacted to a large extent by the results of Syndicate 33. Until 2005, the Group had in general only received cash from the syndicate following the closure of a year of account at the end of three years, except when Lloyd's allowed early profit distributions subject to solvency requirements. However, for 2006, syndicate cash distribution will be determined on a one-year accounting basis, although still subject to solvency requirements.

## Cash flows for 2005

Net cash inflow from operating activities during the year was £18.9 million (2004: £38.5 million), reflecting a strong contribution from the growing and increasingly profitable insurance company and investment income generated from Group cash and investments. Cash flow from Syndicate 33 was good, with few payments being made for the 2005 hurricane losses in the year although there were some outgoings on the 2004 hurricane losses. The Rights Issue resulted in a net inflow of £170 million and US$208 million was drawn from the US$225 million loan facility to capitalise the new insurance company in Bermuda.

Group cash outflows included £2.6 million (2004: £1.4 million) of interest payments. Capital expenditure was £4.5 million (2004: £5.6 million) and dividend payments for the year totalled £16.9 million (2004: £12.8 million).

The Group's cash management strategy is to invest cash that is surplus to immediate operating requirements in high quality debt and fixed income securities of short duration. In general, the investment portfolio produces relatively steady cash returns during periods of interest rate stability. Where interest rates are lower for sustained periods, investment income typically reduces, as the proceeds from higher-yielding securities are reinvested at lower prevailing market rates. However, it is still possible to realise a partial cash flow benefit in a low interest rate environment, since the underlying market value of the investments tends to increase, leading to higher realised cash gains from their eventual sale.

## Liquidity of debt and fixed income securities

The contractual maturity profile of the Group's debt and fixed income securities as at 31 December 2005 is in the table below.

It should be noted that length of contract does not preclude the Group from realising the value of its securities for cash in a prompt and reasonable manner as and when required.

### Cash flow

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Net cash flows from operating activities | 18,917 | 38,523 |
| Net cash used in investing activities | (2,421) | (9,742) |
| Net cash flows from financing activities | 276,289 | (11,054) |
| Net increase in cash and cash equivalents | 292,785 | 17,727 |

### Maturity of debt and fixed income securities

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Less than one year | 167,175 | 309,353 |
| Between one and two years | 295,897 | 135,032 |
| Between three and five years | 327,522 | 255,723 |
| Over five years | 174,660 | 95,098 |
| Sub-total | 965,254 | 795,206 |
| Perpetual notes and other non-dated instruments | 63,541 | 38,757 |
| Total debt and fixed income securities | 1,028,795 | 833,963 |

# Capital

## Overview
Hiscox is strongly capitalised with a stable asset and shareholder base. Its activities are funded by a mixture of equity, retained earnings, letters of credit, bank debt and other third-party insurance capital. Group assets are invested predominantly in bonds with high credit ratings, to ensure a high liquidity and to limit investment risk in the capital base.

The Directors ensure that the use and allocation of capital are given a primary focus in all significant operational actions. Over the last five years, the Group has developed and embedded sophisticated capital modelling tools within its business. These join together short-term and long-term business plans and link divisional aspirations with the Group's overall strategy. The models provide the basis of the allocation of capital to different businesses and business lines, as well as the regulatory and rating agency capital processes.

## Gearing
The Group's ability to increase or decrease the volumes of business that it can underwrite relates directly to its level of capital. Hiscox utilises short to medium-term gearing as an additional source of funds to maximise the opportunities from strong markets and to de-risk the business when the rating environment shows a weaker model for the more volatile business.

The Group's gearing is obtained from a number of sources, including:

- letters of credit – in November 2005 the Group secured a £137.5 million facility from a syndicate of banks at a margin of 1.1 per cent
- term and revolving loan facility – also in November 2005, the Group secured a US$225 million facility at 1.3 per cent margin
- external Names – 27 per cent of Syndicate 33's capacity is capitalised by third parties paying a profit share of approximately 17.5 per cent
- gearing quota shares – historically the Group has used reinsurance capital to fund its capital requirement for short-term expansions in the volume of business underwritten by the syndicate
- qualifying quota shares – these are reinsurance arrangements that allow the Group to increase the amount of premium it writes in strong markets.

The funds raised through letters of credit and loan facilities in 2005 have been applied to support both the 2006 year of account for Syndicate 33 and the capital requirements of the new insurance company in Bermuda.

## Capital position
Strategic expansion in its existing business and the entry into Bermuda during the year afforded the Group opportunities to further optimise its capital position. In view of the favourable rating outlook and market conditions for raising additional equity, the Group completed a Rights Issue on 8 November 2005 that raised £170 million, net of expenses. The Board was particularly pleased with the support shown by shareholders in taking up some 98.7 per cent of the offer, and also with the low level of discount reflected in the issue price. All of the proceeds have been used to establish the Group's new insurance operation in Bermuda, which has a capital base of approximately US$500 million.

## Financial strength
Standard & Poor's and A.M. Best's ratings of the financial strength of the UK insurance company were unchanged at A- during the year. On 12 December 2005, A.M. Best initiated an A- (Excellent) rating for the newly established Hiscox Insurance Company (Bermuda) Limited. On 31 March 2006, A.M. Best initiated an A- (Excellent) rating for Hiscox Insurance Company (Guernsey) Limited. Syndicate 33 benefits from the Lloyd's A global rating. The Group is confident of maintaining these excellent ratings.

## Capital performance
The Group's main capital performance measure is the achieved return on capital employed (ROCE). This marker best aligns the aspirations of employees and shareholders. As variable remuneration, the vesting of options and longer-term investment plans all relate directly to ROCE, this concept is embedded in the workings and culture of Hiscox.

## Capital modelling and regulation
The capital requirements of an insurance group are determined by its exposure to risk and the solvency criteria established by management and statutory regulations. Hiscox is compliant by a significant margin on every prescribed capital test.

In 2005, the Financial Services Authority (FSA) and Lloyd's introduced a new capital regime that gives insurance companies the chance to calculate their own capital requirements through Individual Capital Assessments (ICA). Hiscox Insurance Company and Syndicate 33 have now developed their ICA models.

The models are concentrated specifically on the particular product lines, market conditions and risk appetite of each entity. If the FSA considers an ICA to be inadequate, it can require the entity to maintain an increased capital safeguard. The Directors are also required to certify that the Group has complied, in all material aspects, with the provisions of the Interim Prudential Sourcebook and the Integrated Prudential Sourcebook (PRU) for insurers.

Hiscox used its own integrated modelling expertise to produce the ICA calculations. The results mirrored those driving the existing internal capital setting process.

The assessed capital requirement for the business placed through Hiscox Insurance Company Limited is driven by the level of resources necessary to hold an A rating. The Group's internal work on the ICA of Hiscox Insurance Company has produced results that support the level of capital required by the models of the rating agencies.

For Syndicate 33, the ICA process produces a result that is grossed up by Lloyd's to identify the capital required to hold the A rating. It is pleasing to note that the strong control and risk management environment, together with the sophistication of the modelling, have produced a capital ratio below that suggested under the previous risk-based capital regime.

Another key area of capital modelling for Hiscox is to identify which carrier produces the best return on capital employed for the Group, given certain restraints from licences, reinsurance and the regulatory environment. This modelling takes into account transactional costs and tax, in addition to the necessary capital ratios. It proves the capital efficiency of Lloyd's, despite a tax disadvantage against offshore entities, and the cost advantage of processing smaller premium business outside of Lloyd's.

In addition to the ICA modelling process, the EU Insurance Group's Directive of 1998 (IGD), as amended in 2002, compels insurance companies that are members of a group to consider the solvency margin of their ultimate parent company. This consideration must refer to the surplus assets of the ultimate parent's related insurers, reinsurers, intermediate holding companies and other regulated entities.

The IGD has been applied in the UK through PRU with effect from 31 December 2004. In accordance with PRU, the parent company's solvency margin consideration will become a minimum capital requirement for the Group from 31 December 2006.

The estimated regulatory capital position of the Group under IGD at 31 December 2005 was a surplus of £343 million (2004: surplus of £168 million), which is calculated as below. The final audited regulatory capital position will be submitted to the FSA before 30 April 2006 in accordance with the required regulatory timetable.

The improvement in the Group's IGD surplus during 2005 relates mainly to the capital contributed by shareholders through the Rights Issue and the profitable result for the year.

In the Group's other geographical territories, including the USA, it is required to operate within broadly similar risk-based capital requirements when accepting business.

## Capital position (Unaudited)

| | 31 December 2005 £m | 31 December 2004 £m |
|---|---|---|
| Group capital resources | 494 | 310 |
| Group capital resources requirement | (151) | (142) |
| Surplus | 343 | 168 |

# Risk management

Hiscox is an insurance business that is primarily involved in the evaluation and acceptance of risk. Consequently, the management of risk permeates every level of decision making in the Group. It is intrinsic to the underwriting and reinsurance strategy, inherent in the craft of managing the resulting investments and uppermost in the minds of staff settling claims and closing exposures.

In short, a culture of risk management pervades the entire Group.

The appetite for all aspects of risk is set by the main Board and cascaded down into the Group's operations through a well designed structure of management committees. These committees are assigned specific areas of focus, such as underwriting, loss modelling, reinsurance purchase and security, investments and claims reserving.

The committees oversee the procedures for delegating authority and powers to accept risk to the Group's staff. They are tasked with embedding strategies to identify and manage all significant risks relevant to their respective areas. The committees report separately into a formal oversight committee that comprises executive Board Directors and other senior management. This mechanism enables the Board to be quick and decisive in dealing with unacceptable levels of risk when they arise.

In parallel with these direct risk management processes, the Board uses Internal Audit and a dedicated risk management function to monitor and review the effectiveness of risk management throughout the organisation.

The major risks that the Group faces are presented below. A number of these factors are common to all insurance businesses, while others are relevant to Hiscox specifically. For a discussion of the major risks and uncertainties impacting the Group's financial statements, see note 4 to the financial statements.

## Catastrophe and systemic insurance losses

In common with other insurers, the Group's earnings can be affected by unpredictable events and circumstances. These may include, but are not limited to, conditions such as natural and other catastrophes, legal developments, social change and the emergence of latent risks. Such events could create significant levels of losses if the Group's underwriting models, aggregation tools and policy wordings do not prevent unplanned concentrations of risk, both in geographical regions and types of policy.

The failure to manage concentrations of exposure is therefore the single greatest risk to Hiscox.

The Group continues to underwrite significant risks in geographical regions that are prone to natural peril. This book of business remains a compelling proposition for the Group, since it is capable of returning impressive margins over the medium- to long-term as the occurrence of catastrophes averages out.

By its nature, this business requires that underwriting staff exercise the greatest levels of foresight. Accordingly, the Group has invested heavily to develop robust risk management and mitigation techniques so that it is well prepared for the unique challenges that these risks present. These techniques are designed to shield the core capital base of the Group against unexpected, repeat clusters of all but the most intense and destructive of events.

The portfolio of risks is actively managed to maintain a balanced and diversified book within defined agreed limits at local and regional levels. This is supported by the use of sophisticated exposure aggregation and scenario modelling tools and ultimately by the purchase of a reinsurance programme designed to cap losses from concentrations of risks. Policy wordings are also reviewed regularly in the light of legal developments to ensure that the Group's exposure is restricted, where possible, to those risks identified at the time of policy issuance.

The design of the underwriting and reinsurance programmes, and the associated control of aggregate exposures around the Group, are fundamental to the risk profile of Hiscox. The modelling and monitoring systems are deployed both in the underwriting process and by independent risk specialists. The models are used to design the insurance and reinsurance programmes and control the business that is written to ensure that the risk profiles of contracts match the exposures for which the programmes were devised.

Aggregation and modelling resources are shared across the entire Group. Management at the new Hiscox operation in Bermuda is therefore able to adopt the Group's existing methodologies and models, albeit tailored to the intricacies of that particular market.

Hiscox also runs realistic disaster scenario projections for each Group entity and for the Group as a whole. The Group's maximum net retentions based on the estimated losses from these scenarios are outlined in note 4.1 to the financial statements.

The Group's performance relative to the unprecedented impact of catastrophes on the industry in recent years highlights the ability of its models to suggest precise and logical reinsurance placements. It also shows the distinctive benefits that Hiscox derives from its diversification in coverage and geography. By writing a well diversified book with a large focus on uncorrelated retail business, Hiscox is able to offset losses on its more volatile accounts.

## Competition and the insurance cycle

The principal markets for the Group's products continue to grow. Hiscox companies are expanding further into the USA and Bermuda and extending their regional presence in the UK and Europe.

In all of these markets around the world, Hiscox competes against major international groups with very similar offerings. At times, a minority of these groups may choose to underwrite for cash flow or market share purposes and at prices that sometimes fall short of the suggested breakeven technical price.

The Group is firm in its resolve to reject business that is unlikely to generate underwriting profits. Accepting insurance risk below technical price is detrimental to the industry's prospects, since it drives the prevailing rates in the market lower to the point where business failures occur, insurers' capital is destroyed, customers receive sub optimal service and the industry suffers from negative publicity. As capacity levels in the market fall, prices inevitably rise until the point where the cycle of irrational pricing may begin again.

In common with all insurers, the Group is exposed to this price volatility. Accordingly, prolonged periods of low premium rating levels or high levels of competition in the insurance markets are likely to have a negative impact on the Group's financial performance. However, pricing levels are monitored on a continuous basis with monthly reports showing both current levels and trends over the past 12 months throughout a wide range of products.

To counter this, Hiscox alters its appetite for the lines of business and the layers it writes within them in response to market conditions and the risk appetite of the Group. The Group's cycle management strategy and related modelling and monitoring are essential to ensure that it controls any accumulating adverse effects of changes, such as a move to higher or more volatile layers. As the Group frequently acts as the lead insurer in the complex co-insurance programmes required to cover significant high value assets, it has some ability to set market rates rather than follow them.

Mutualisation is a related risk arising from the phenomenon of pricing cycles in the industry. The Group is required to contribute towards obligations arising from poorly priced risks accepted by other insurers who subsequently fail. Syndicate 33 contributes to the New Central Fund, which is a policyholders' protection fund that the Council of Lloyd's operates to make payments when other Lloyd's Names fail to pay valid claims. In the UK, certain Hiscox entities are required to pay a percentage of net premium income on certain policies to the Financial Services Compensation Scheme (FSCS), which is a statutory fund that compensates, to agreed levels, policyholders affected by insolvent insurers. Should the level of failures escalate, the Group could be subject to additional or special levies by Lloyd's or the FSCS.

The Group's executives have long recognised that the future of Hiscox is linked, in some part, to the fortunes and conduct of its competitors. Consequently, the Group participates in many industry bodies, associations and task force initiatives in order to monitor developments and influence their strategic direction. In particular, the involvement of the Group's executives in the reshaping of the Lloyd's market over the last decade underscores that commitment.

## Binding authorities and other outsourcing

Hiscox writes a considerable amount of premium income through agents to whom binding authority is given to accept risks on behalf of Hiscox Group carriers. Binder management exists as a separate discipline outside of the underwriting process at Hiscox. All delegations are strictly controlled through tight underwriting guidelines and limits and extensive monitoring, review and auditing of the agencies. However, as there is no absolute guarantee that an agent will comply with the terms of its authority, Hiscox could be exposed to uncontemplated losses.

Other business areas where the Group is to some extent reliant on the timely and effective supply of services from third parties include back office policy processing, data entry and cash collection. Although the Group manages these relationships to ensure continuity and quality of service, events could occur beyond its control that could affect these third parties and in turn impact on the Group's performance.

The Group selects all of its agents and business partners carefully. All significant areas of outsourcing undergo a rigorous tendering process, where numerous attributes other than just price competitiveness are given due consideration. All third parties operate within the terms of formal service level agreements, with repercussions for underperformance.

## Credit risk with reinsurance counterparties

The Group purchases reinsurance protection to contain exposure against its capital from single claims and the aggregation of claims from catastrophic events.

The Group places reinsurance with companies that it believes are strong financially and operationally. The limits on reinsurance counterparty risk are set by the Reinsurance Security Committee, which meets regularly under the chairmanship of the Group Finance Director. Evaluation criteria include financial strength, trading record, payment history, outlook and organisational structures. Information is drawn from the following sources: public information produced by the Company; the Group's experience with the reinsurer and knowledge of their behaviour in the marketplace; analysis from a reinsurance consultant; rating agency commentary and gradings.

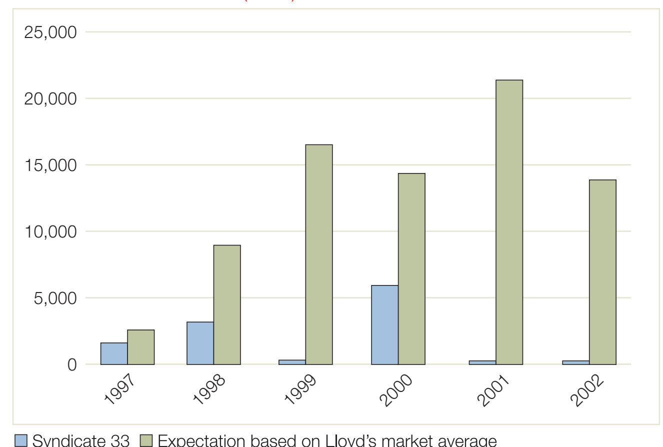
An analysis of the insurance assets receivable from the Group's major reinsurance partners, by reference to their underlying Standard & Poor's or equivalent ratings, at 31 December is as follows:

| | 31 December 2005 £000 | 31 December 2004 £000 |
|---|---|---|
| AAA | 28,481 | 11,670 |
| AA | 162,066 | 81,530 |
| A | 317,081 | 132,899 |
| Other/not rated | 46,210 | 47,160 |
| Total | 553,838 | 273,259 |

The Group's experience of bad debt losses arising from its reinsurance arrangements compares favourably with industry averages. Its largest insurance carrier, Syndicate 33 at Lloyd's, has experienced better than average recoveries from its reinsurance placements on a consistent basis.

In addition, neither Hiscox Insurance Company Limited nor Hiscox Insurance Company (Guernsey) Limited has incurred bad debt expenses of any significance for the period covered in the table below.

Note: this table compares Syndicate 33's performance at the 100 per cent level against that which could have been expected to occur had it suffered the same percentage of bad debts as the Lloyd's market average. Figures for the Lloyd's market average are based on published bad debt expenses as a percentage of reinsurance recoveries at the 36 months stage, for each year of account. The 2002 result at the 36 months stage is the most recent figure published by Lloyd's.



# Risk management continued

## Claims volatility

The Group establishes provisions for unpaid claims, defence costs and related expenses to cover its ultimate liability in respect of both reported claims and incurred but not reported (IBNR) claims. These provisions take into account both the Group's and the industry's experience of similar business, historical trends in reserving patterns and loss payments and pending levels of unpaid claims and awards.

The Group's in-house actuarial teams prepare estimates after discussions with underwriting and claims management staff. In addition, annual reviews are conducted by external advisors, and formal actuarial auditors in the case of Syndicate 33 who have close and relevant experience of current claims development trends in the industry. The results of these reviews are given considerable weighting in determining any adjustments that may be required to existing reserves.

Reserve estimates are subject to regular monthly reviews. Adjustments are made to take into account management's latest view of the probable ultimate liability, based on claims and other developments and new data. Yet there can be no absolute guarantee that the ultimate losses will not differ materially from the provisions the Group has established. It is particularly difficult to estimate IBNR claims and those arising from large catastrophes.

Note 25 to the financial statements provides information on the Group's estimation of ultimate claim costs over recent years. Additional information is provided in note 4 to the financial statements and the corporate governance section.

## Business continuity

It is critical for Hiscox that the key resources required to support insurance underwriting and other essential business activities continue to be available. Consequently, the Group has taken significant steps to mitigate the impact of business interruptions that may result from a variety of events, including the loss of key individuals and facilities such as premises, computer networks and telephony.

The Group's business could be affected adversely if staff were to be prevented from using its major premises for any reason. Whereas five years ago the vast majority of Hiscox personnel were based in a single location in London, today the Group's staff are more widely distributed. With offices around the UK, Europe, USA, Bermuda and Guernsey, less than half of the Group's personnel are now based in London. This geographical dispersion reduces the Group's exposure to natural, operational and terrorist events that could prevent access to its premises.

The business also relies to a significant extent on IT and telecommunications systems. Whilst the Group considers its systems to be resilient, their failure or impairment, or the inability to transfer data onto any new systems introduced, could cause a loss of business and/or damage to the reputation of the Hiscox Group, as well as remedial costs.

The most difficult continuity risk for Hiscox to manage is the loss of key staff. The recruitment and retention of high quality people is of fundamental importance to Hiscox and the Group takes the risk of losing such assets very seriously. To maintain the loyalty of staff, the Group provides competitive remuneration packages and benefits and a unique culture that embraces the individual and their aspirations. In March 2006, Hiscox appeared in The Sunday Times 100 Best Companies To Work For rankings for the fourth successive year. It has previously been voted the number one employer in the financial services sector.

In the event that key staff do leave, the Group's contingency plans ensure continuity of service both internally and to policyholders. These include cross-training and rotation of duties to ensure that staff can perform multiple roles. Most staff work in teams rather than in isolation, which lessens the impact of normal staff turnover on the business.

Hiscox has a formal disaster recovery plan that addresses its premises and technology related risks. Robust contingency strategies are in place for both workspace recovery and back up of data-centres and telephony. In the event of an outage, these procedures will enable the Group to move operations to alternative facilities within very short periods of time. The alternative facilities are supplied by separate localised utility grids and telecommunications carriers.

The disaster recovery plan is tested regularly and the Group also performs disaster simulations.

## Currency fluctuations

The US dollar is the Group's largest underwriting currency. A significant proportion of the Group's US dollar insurance liabilities are supported by investments held in the same currency. However, as a significant proportion of the Group's operational cost base is located in the UK and Europe, movements in foreign exchange rates may have a material adverse effect on its financial performance and position.

Further details of the Group's investment profile and its management of currency risks are provided in notes 4, 19 and 21 to the financial statements.

## Investment returns

The Group's entities hold significant portfolios of investments to support their obligations, including their insurance liabilities, and their profits depend in part upon the returns that these achieve. Changes in interest rates, equity returns and other economic variables can therefore affect the Group's financial performance substantially.

A fall in the capital value of their investments could result in a reduction in the level of business that each entity is able to underwrite. In addition, a major insurance loss or unexpected sequence of attritional losses could result in a sustained cash outflow that might require the early realisation of investments on unfavourable terms.

The Group has a detailed investment strategy that seeks to minimise the concentration of investment risk in any one particular sector or issuer. It retains the majority of its assets in high quality short duration debt securities and fixed term deposits, further details of which are provided in notes 4 and 19 to the financial statements.

## Regulatory issues

The Group's entities are incorporated and transact business in a variety of countries and states, all of which require strong levels of accountability to the local regulatory authorities.

The various Hiscox businesses operating in the UK are subject to high levels of regulation from the FSA and the Council of Lloyd's. The numerous regulatory bodies that oversee the Group's international operations include the Guernsey Financial Services Commission, the Bermuda Monetary Authority and individual state insurance departments in the USA. These bodies all have significant powers of intervention including the ultimate sanction of removing the authorisation to carry on insurance business.

Regulatory action could affect the Group's results and position in numerous ways. For example, it could be required to allocate inefficient levels of capital around the Group in order to overcome minimum regulatory hurdles, or bear the costs of implementing new compliance or sophisticated computer modelling systems. Continual changes in, or inappropriate levels of, regulation in the Group's markets could also result in their becoming uncompetitive or unattractive to customers, which might lead them to place their insurance business in other alternative markets in which the Group has no presence.

Hiscox devotes considerable resources throughout the Group to meet its regulatory obligations. The senior management of each Hiscox business maintain constructive, productive and valuable relationships with all of the regulatory bodies in their respective territories. Furthermore, the Group debates all current regulatory issues and encourages the development of new initiatives in areas such as risk management and reporting that will help safeguard the future of the industry.

## Rating agencies

The ability of the Group's insurance operations to write certain classes of business, including reinsurance inwards business, may be affected by a change in the financial strength or credit rating issued by an accredited rating agency such as A.M. Best, Moody's or Standard & Poor's.

Syndicate 33 has its own rating and also benefits from the Lloyd's global rating. The Lloyd's rating could be affected by matters outside of the Group's influence or control. Hiscox Insurance Company Limited, Hiscox Insurance Company (Guernsey) Limited and Hiscox Insurance Company (Bermuda) Limited have their own separate ratings from accredited agencies.

A downgrading of the ratings of Lloyd's, Syndicate 33, Hiscox Insurance Company Limited, Hiscox Insurance Company (Guernsey) Limited or Hiscox Insurance Company (Bermuda) Limited could have a material adverse impact. The Group might cease to meet the security criteria of brokers, resulting in a loss of new business, policy cancellations and non-renewals. The Group's borrowing facilities might also be subject to review.

The Group enjoys an excellent relationship with the agencies that rate its entities. Group senior management hold several meetings with representatives from the agencies each year and gives due consideration to the likelihood of rating consequences before executing any significant strategic action.

# Corporate responsibility

Fundamental to corporate and social responsibility is honest and fair dealing in all activities of the Company. Hiscox has always been extremely conscious of its reputation. Management has always believed that a reputation for integrity and decent behaviour in all dealings, be they within the Group or with those from outside who come in contact with the Group, will be good for morale and for the results of the business.

Robert Hiscox

The Group's commitment to responsible business practices is reflected in:

- being placed in The Sunday Times 100 Best Companies To Work For for the last four years
- active involvement in helping local communities
- pioneering plain English insurance policies with a culture of rapid and fair claims handling
- open communication with all stakeholders
- its inclusion in the FTSE4Good UK Index
- being awarded the Platinum Clean City Award for five consecutive years, for our care for the environment.

Hiscox supports the ten principles of the United Nations Global Compact in respect of human rights, labour, the protection of the environment and anti-corruption and strives to support and advance those principles within its sphere of influence.

## Helping customers and treating them fairly

Hiscox is dedicated to advising customers on risk management to prevent burglary and fire in the home and other distressing losses. Should a loss occur, we appreciate that insurance is a promise to pay, and our claims service aims to support our customers and make them whole as soon as possible.

Hiscox also provides high quality risk management advice for commercial customers and again, should a loss occur, its claims settlement aims to restore business continuity with minimum disruption.

The Group pioneered the use of clear wordings on insurance policies, especially those intended for private customers. In addition, policies are normally inclusive, which means that risks are covered unless excluded specifically.

Customer feedback is considered carefully and used to enhance future products and services.

## Employees

Hiscox wants to employ the best people and provide them with the means and the motivation to excel. Obviously, this will be achieved with fair rewards and by providing staff with an environment in which they can enjoy their work and reach their full potential.

Hiscox recognises how important it is for employees to maintain a healthy work-life balance and gives staff the option of flexible and home working wherever possible.

### *Equal opportunities*

Hiscox is committed to providing equal opportunities to all employees and potential employees in all aspects of employment regardless of disability, sex, race, sexual inclination or background.

### *Rewards and benefits*

Hiscox encourages employees to identify with the success of the Group through performance-related pay and bonus schemes, savings-related share option schemes and executive share option schemes. Competitive benefits packages contain health, fitness, flexible working and career break opportunities. Salary packages are benchmarked by Watson Wyatt against the financial services industry as a whole and against the Lloyd's market specifically.

During 2005, staff retention was 87 per cent.

### *Training and development*
Hiscox is committed to training and developing its employees to help them to maximise their potential. Each permanent member of staff is provided with a tailored personal development programme. Training and development needs are reviewed twice a year, along with performance, against clearly set objectives.

### *Communication and participation*
Employees are kept informed of business developments through formal briefings, team meetings, intranet bulletins, video conferences and informal routes. Management takes these opportunities to listen to staff and involve them in taking the business forward. A quarterly staff magazine provides updates on issues and social events.

### *Culture*
The Hiscox culture is underpinned by a set of core values that determine the standard of behaviour expected of employees. These core values guide everything that Hiscox does in its business. By conducting its business with these core values in mind, the Group recognises that it is more likely to achieve business success and create value for its shareholders.

Hiscox strives for the highest standards of corporate governance while being in essence a non-bureaucratic organisation. An effective and firm system of internal controls ensures that risks are managed within acceptable limits, but not at the expense of innovation or speed of response. The Group believes that it has got this balance right and that it is one of its greatest strengths.

The Group's policies ensure that it continues to follow a best practice approach to managing its people and remains a fair and professional employer. In the unlikely event of an employee having a material concern relating to the operations of the business, a whistleblowing policy explains to staff how they can confidentially raise their misgivings. Hiscox also subscribes to Public Concern at Work, which provides free legal advice to any employee with a concern about possible danger or malpractice in the workplace.

### *Local culture*
As the Group expands throughout the world, it aims to recruit local staff wherever possible to help develop a rapport with the local community and make a direct contribution to the local economy.

## Community involvement
The Group has maintained its involvement in its local communities with the strong support of its employees. The reading partners scheme has continued, through which staff assist pupils at the Elizabeth Selby Infants School in Tower Hamlets. Employees also mentor students at Morpeth School in Tower Hamlets.

Hiscox is also a member of the Lloyd's Community programme, which supports local initiatives concerning education, training, enterprise and regeneration.

Hiscox supports the Wiltshire Bobby Van Trust, which installs security in the homes of elderly, disadvantaged or vulnerable people in Wiltshire.

Hiscox Art Projects continues to provide talented artists with opportunities to exhibit their art. In 2005 Hiscox sponsored the Glasgow School of Arts and The École Nationale Supérieur des Beaux-Arts in Paris, degree shows. It also supported the Paintings in Hospitals charity.

The Hiscox Foundation gives charitable donations to deserving causes. It gives priority to any charity in which a member of staff is involved with the aim of encouraging such activity. For instance, in 2005 a team of 25 employees undertook the Three Peaks Challenge, raising some £8,000 for the Richard House Hospice including support from The Hiscox Foundation.

This local hospice, which provides respite and care for children and young people not expected to live into adulthood, is the beneficiary of much of the staff's charitable fundraising.

### *Stakeholder engagement*
The Hiscox senior management makes it a priority to keep its stakeholders fully informed.

Brokers are an important Hiscox stakeholder. Hiscox endeavours to have good relationships with them to create a competitive advantage in the marketplace. Clear communications are key to good relations and a quarterly Hiscox broker magazine keeps brokers informed of developments at Hiscox and in the insurance industry.

## Energy and the environment
The way our insureds conduct their business is of paramount importance to us, due to our core philosophy that for high-quality underwriting we need high-quality insureds. In considering underwriting, the insureds' attitudes to all aspects of their business, including their care of the environment, are considered.

The Group's direct environmental impact is mainly from the energy it uses and the emissions and waste it generates from its premises. In accordance with the Group's Environmental Policy, consumables are recycled and reused wherever possible. The Group is taking steps to reduce the amount of raw materials used in business processes and by staff particularly through the extensive use of computerisation and communications technology. During 2006 and 2007, Hiscox will begin upgrading its computer printers to multi-function devices capable of scanning, photocopying, and double-sided printing. This should reduce the cost of consumables and waste volumes and increase the efficiency of document storage, search and retrieval.

Programmes for recycling batteries, mobile phones, lamps and CDs continued during the year. The Group's efforts were rewarded by a Platinum Award from the City of London Corporation for the fifth year in succession. A Hiscox representative attends meetings organised by the City of London Corporation to keep abreast of environmental best practice and exchange ideas with other like-minded companies.

# Corporate governance

## The Combined Code

Hiscox is committed to high standards of corporate governance, and for the year ended 31 December 2005 and the period up to the date of approving the accounts, the Group has applied the principles and complied with the provisions set out in section 1 of the revised Combined Code published in July 2003, with the following exceptions:

Stephen Hall, Senior Independent Director for the year until his retirement on 31 December 2005, had served for more than nine years but was nevertheless considered independent by the Board by virtue of his character and objectivity.

With the exception of the unavoidable absence of Carol Franklin Engler, all the Directors attended the Annual General Meeting.

## The Board of Directors

The Board comprises four Executive Directors and five independent Non Executive Directors, including a Senior Independent Director. Brief biographical details for each member of the Board are provided on pages 4 and 5.

The roles and activities of the Chairman and Chief Executive are distinct and separate. The Chairman is responsible for running an effective Board and overall strategy, and the Chief Executive has executive responsibility for running the Group's business.

In accordance with the Company's Articles of Association, all Directors are required to submit themselves for re-election by the shareholders at least every three years.

Anthony Howland Jackson succeeded Stephen Hall as Senior Independent Director on 1 January 2006.

All Directors are entitled to seek independent professional advice at the Company's expense. A copy of the advice is provided to the Company Secretary who will circulate it to all Directors. No such advice was sought during the year.

The Board meets at least four times a year and operates within established terms of reference. It is supplied with appropriate and timely information to enable it to review business strategy, trading performance, business risks and opportunities. During 2005 the Board met six times.

The Board delegates operational management of the trading entities and divisions to their own Boards but reserves certain matters for itself, including: setting group strategy, approving significant mergers or acquisitions, approving the financial statements, declaration of the interim dividend and recommendation of the final dividend, approving group business plans and budgets, approving major new areas of business, approving capital raising, setting Group investment guidelines, approving the Directors' remuneration, approving significant expenditure or projects, and approving the issue of share options.

## The Board's committees

The Board has appointed and authorised a number of committees to manage aspects of the Group's affairs. Each committee operates within established written terms of reference and each committee Chairman reports directly to the Board.

## The Audit Committee

The Audit Committee comprised Stephen Hall as Chairman of the Committee together with Anthony Howland Jackson, Derek Netherton and Carol Franklin Engler until July 2005 at which time Adrian Auer joined the Committee. Adrian Auer succeeded Stephen Hall as Committee Chairman on 1 January 2006 and is considered by the Board to have recent and relevant financial experience.

The Audit Committee meets at least four times a year to assist the Board on matters of financial reporting, risk management and internal control.

The internal and external auditors have unrestricted access to the Audit Committee, which monitors the scope, results and cost effectiveness of the internal and external audit functions, the independence and objectivity of the external auditors, and the nature and extent of non-audit work undertaken by the external auditors together with the level of related fees. All non-audit work undertaken by the Group's external auditors with fees greater than £50,000 must be pre-approved by the Audit Committee. KPMG Audit Plc has confirmed to the Audit Committee that in its opinion it remains independent. The Committee is satisfied that this is the case.

## The Nomination Committee

The Nomination Committee is chaired by Carol Franklin Engler and comprises the Group Chairman, Robert Hiscox, and all the non executive directors. It meets as and when required to deal with appointments to the Board and employs external search and recruitment agencies when considering new appointments. The Committee met twice during the year.

## The Remuneration Committee

The Remuneration Committee comprised Anthony Howland Jackson as Committee Chairman, Stephen Hall, Derek Netherton and Carol Franklin Engler between 1 January and 30 June 2005. Adrian Auer and Sir Mervyn Pedelty were appointed to the Committee on 1 July 2005. Stephen Hall retired on 31 December 2005.

The Remuneration Committee meets at least twice a year and recommends to the Board a framework of executive remuneration, and also determines on the Board's behalf the specific remuneration packages for each of the Executive Directors, including pension rights and any compensation payments. The Directors' Remuneration Report is presented on pages 41 to 43.

## The Conflict Committee

The Conflict Committee is chaired by Anthony Howland Jackson and comprises all the independent non executive directors. It meets as and when required. Should a potential conflict of interest arise at any time between Group entities, there is a formal procedure to refer the matter to this Committee. The Committee met once during the year.

Conflicts arise from time to time because Syndicate 33 is managed by a Hiscox-owned Lloyd's Managing Agency. 27 per cent of the Names in the Syndicate are third parties; 73 per cent of the Syndicate is owned by a Hiscox Group company. The Conflict Committee serves to protect the interests of the third-party Syndicate Names.

## The Risk Committee

The Risk Committee is chaired by the Chief Executive, and comprises the Group Finance Director, the Head of Compliance & Internal Audit, the Head of Risk, and senior managers from a selection of the Group's divisions. It meets monthly to monitor the risk management framework and makes reports to the Board and Audit Committee.

It also plays an important role in promoting and developing good risk management practice as well as identifying emerging risks and recommending appropriate risk management strategies.

The Committee receives information from internal audit as well as conducting its own reviews at strategic, tactical and operational levels.

## The Executive Group and the Group Management Team

Two key management committees, the Executive Group and the Group Management Team, sit at the heart of the Group's organisational structure. These committees meet weekly and manage the Group's business operations in order to achieve the Board's strategic business objectives.

## Performance evaluation

During the year, the performance of the Board, its main committees and the individual Directors was formally and rigorously evaluated.

A questionnaire was circulated to Directors concerning the performance of the Board as a whole and of its main committees. The responses were collated, and summarised. Open and frank Board discussions were held concerning the results, and all specific issues raised were addressed.

Having received input from each of the Executive Directors, the Non Executive Directors met under the chairmanship of the Senior Independent Director to discuss and evaluate the Chairman's performance.

The Non Executive Directors also met with the Chairman during the year to discuss a wide range of issues, including the performance of the executive members of the Board.

The Chief Executive held one-to-one meetings with each of the Executive Directors to discuss their performance over the year and to set targets for the year ahead. Similarly, the Chairman evaluated the performance of the Chief Executive and of the Non Executive Directors.

The evaluation process concluded that the Board as a whole and its main committees had functioned well during the year and that the individuals had also performed well, with each making a significant contribution to the Company. The mix of skills on the Board was felt to be appropriate and worked well. The issues identified during the evaluation, such as whether additional time needs to be devoted to the Group in 2006, have been thoroughly discussed and action plans have been put in place where appropriate.

## Shareholder communications

The Executive Directors communicate and meet directly with shareholders and analysts throughout each year, and do not limit this to the period following the release of financial results or other significant announcements.

All Directors endeavour to attend the Annual General Meeting. With the exception of the unavoidable absence of Carol Franklin Engler from the Annual General Meeting, all the Directors attended both the general meetings held during the year.

In addition to the Executive Directors, the Senior Independent Director attends the six-monthly analysts' meeting. The Company also commissions independent research on feedback from shareholders and analysts on a regular basis following the Company's results announcements. This research together with the analysts' research notes are copied to the Non Executive Directors in full. The Chairman attends a number of meetings with shareholders as well as speaking at the analysts' presentations. In addition, any specific items covered in letters received from major shareholders are reported to the Board.

Major shareholders are invited to request meetings with the Senior Independent Director and/or the other Non Executive Directors, and they have been given the contact details of the Senior Independent Director.

An alert service is available on www.hiscox.com to notify any stakeholder of new stock exchange announcements.

## Embedded risk management framework

The Directors are responsible for maintaining a sound system of internal control to safeguard shareholders' investment and the Company's assets, and for reviewing its effectiveness. This covers all aspects of risk including insurance risk, market risk, credit risk, operational risk, liquidity risk, social, environmental and ethical risk. This management system has been in place throughout the year and up to the date of approval of the Annual Report, and includes a variety of processes to identify, assess and manage the different classes of risk in the manner most appropriate to each class. The Board has reviewed the effectiveness of internal controls during 2005 and confirms there is an ongoing process for identifying, evaluating and managing the significant risks faced by the Company, and that it accords with the guidance in the document, 'Internal Control: Guidance for Directors on the Combined Code'.

Hiscox acknowledges that it is neither possible, nor desirable, to eliminate risk completely. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss. The constant aim is to be fully aware of the risks to which the business is exposed and to manage these risks to acceptable levels.

Key senior management responsibilities are clearly identified together with their reporting lines to the relevant Executive Directors. Terms of reference and reporting lines are in place for all key decision making and monitoring committees including the committees mentioned above. In addition, there is a dedicated Risk Department which liaises regularly with Internal Audit, and the Head of Risk reports to the respective Boards and committees on a regular basis.

## Board meetings and attendance

| | Board | | Audit | | Remuneration | | Nomination | |
|---|---|---|---|---|---|---|---|---|
| | Number of meetings | Number attended | Number of meetings | Number attended | Number of meetings | Number attended | Number of meetings | Number attended |
| RRS Hiscox | 6 | 6 | N/A | N/A | N/A | N/A | 2 | 2 |
| BE Masojada | 6 | 6 | N/A | N/A | N/A | N/A | N/A | N/A |
| SJ Bridges | 6 | 6 | N/A | N/A | N/A | N/A | N/A | N/A |
| RS Childs | 6 | 6 | N/A | N/A | N/A | N/A | N/A | N/A |
| SH Hall | 6 | 6 | 5 | 5 | 2 | 1 | 2 | 1 |
| AGC Howland Jackson | 6 | 4 | 5 | 4 | 2 | 2 | 2 | 2 |
| DND Netherton | 6 | 5 | 5 | 4 | 2 | 1 | 2 | 2 |
| C Franklin Engler | 6 | 6 | 5 | 4 | 2 | 1 | 2 | 2 |
| AR Auer | 4 | 4 | 3 | 3 | – | – | – | – |
| Sir Mervyn Pedelty | 4 | 3 | N/A | N/A | – | – | – | – |

The execution of each delegated responsibility, by individuals and committees, is closely monitored by regular reporting to, and challenge by, the Board and its committees. This monitoring, supported by financial and non-financial management information, covers performance against agreed targets and objectives, as well as the risks to achieving these objectives and the effectiveness of the measures in place to manage these risks. Feedback and discussion within this reporting structure allow the Board to determine, communicate and enforce its appetite for the various risks to which the business is exposed.

Hiscox's culture of open communication and delegated responsibility allows this framework of embedded risk management to function well throughout the organisation, enabling rapid responses to the evolving risks to the business.

The internal audit function is responsible for providing independent assurance directly to the Audit Committee on the adequacy and effectiveness of the Board's system of risk management and internal control. This assurance is provided by means of an agreed programme of review, responsive work and direct reporting of significant issues. Internal Audit is also responsible for making recommendations at all levels where risk management may be usefully improved and for reporting the acceptance and implementation of significant recommendations to the Audit Committee. This function independently tracks and reports to the Audit Committee on the implementation of its own recommendations and those of the external auditors.

The Turnbull Guidance, 'Internal Control: Guidance for Directors on the Combined Code', was updated by the Financial Reporting Council in October 2005 and is effective for financial years beginning on or after 1 January 2006. The Board welcomes the revised guidance and confirms its intention to follow its recommendations throughout 2006.

Further information concerning Hiscox's approach to risk management is included on pages 32 to 35.

# Directors' remuneration report

This report sets out the remuneration policies for the Group's senior executives for the next and future financial years. The members of the Remuneration Committee are identified on page 38.

None of the Committee has any personal financial interest (other than as shareholders) or conflicts of interests arising from cross-directorships or day-to-day involvement in running the business. The Remuneration Committee makes recommendations to the Board. No Director plays a part in any discussion about his or her own remuneration.

## Remuneration policy

The Remuneration Committee recommends to the Board a framework of executive remuneration and its cost. The Committee also determines on the Board's behalf the specific remuneration packages for each of the Executive Directors, including pension rights and any compensation payments.

The general philosophy underlying the Group's remuneration policy for its senior executives, including Executive Directors, is the same as that applied to all employees, which is to attract and retain quality staff and to encourage and reward superior performance.

Remuneration elsewhere in the Group is considered in determining Directors' remuneration.

## Remuneration elements

There are four components to the remuneration package: base salary and benefits, annual cash bonuses, long-term incentive arrangements and pensions.

## Base salary and benefits

The Remuneration Committee uses reports provided by Watson Wyatt in their capacity as independent remuneration consultants, together with publicly available reports. It considers what comparable companies are paying when setting annual salaries and other benefits. Using this information as a benchmark, and taking into account current economic and operational conditions, salary levels are determined for each individual which take into account experience, skills, development and performance. Watson Wyatt provide no other services to the Company.

## Bonuses

The Remuneration Committee believes that a significant portion of the total remuneration should be attained through an incentive bonus, which links rewards directly with performance. A bonus pool is created when the business profits of the Group, based on the year's pre-tax operating result, exceed a return on equity linked to the longer term rate of return ('Hurdle Return'). The bonus pool is limited to a percentage of profits above the Hurdle Return. Similarly, the bonus pools allocated to each major business division are calculated based on the business profits generated by that division above the Hurdle Return. This pool is utilised to award annual bonuses to all staff, including Executive Directors based upon the performance of their business area and upon their individual performance. In this way, the bonus scheme aligns the interests of Executive Directors and employees with shareholders. The actual amount to be paid to Executive Directors is determined by the Remuneration Committee and is based on the performance of the Group and an assessment of individual performance.

The Remuneration Committee also reviews and confirms the recommendations of management regarding the award of bonuses to senior managers and staff.

## Long-term awards

The Remuneration Committee believes strongly in the value of employee participation in long-term award schemes and operates three share option schemes so that their interests may be aligned with those of shareholders.

Awards were made during the year to Executive Directors, senior executives and other staff under the Hiscox Approved Share Option Scheme and the Hiscox Unapproved Share Option Scheme (the 'Option Schemes'). The exercise of options under these schemes depends upon achieving certain performance targets over a period of three years. These options are not offered at a discount and conform with institutional investor dilution guidelines. All Directors entitled to share options are subject to these same performance criteria.

Awards were also made during the year under the Sharesave Scheme and the International Sharesave Scheme. These schemes provide a medium-term incentive available to all staff. Awards depend upon the amount employees elect to save out of their salary, subject to the maximum figure under the rules. There are no performance criteria for these schemes.

The Remuneration Committee is very pleased with the commitment shown by employees in the future of the Group.

No awards were made during the year under the Hiscox Performance Share Plan (the 'Performance Share Plan') although special awards were subsequently made on 12 January 2006 which were subject to more stretching performance conditions (the 'Special Award'), as approved at the Extraordinary General Meeting of the Company on 6 December 2005.

In order to ensure employees' interests are aligned with shareholders', the Remuneration Committee regularly reviews the terms and conditions of share incentive grants made to employees. The 2003 review resulted in the Remuneration Committee proposing changes to the terms and conditions applying to future grants of options under the Option Schemes and awards under the Performance Share Plan and these amendments were approved and adopted on 22 June 2004. Consequently awards earned under these schemes are currently running with two different sets of terms and conditions.

Exercise of options granted prior to 22 June 2004 under the Performance Share Plan is subject to the following terms:

(a) the participants will receive 100 per cent of the award if the Group's operating EPS over a fixed three year period has increased by 35 per cent ('the maximum target')
(b) no award will vest unless the increase in the Group's operating EPS over the period equals or exceeds 15 per cent ('the minimum target') at which point 40 per cent of the award will vest
(c) an award will vest on a straight-line basis if the operating EPS growth is between the minimum target and the maximum target.

# Directors' remuneration report continued

All options granted under the Option Schemes since 22 June 2004, as well as awards granted under the Performance Share Plan, other than the special award are to be granted in accordance with the revised terms and conditions as follows:

(i) there will be no facility for the re-testing of performance conditions
(ii) the participants will receive 100 per cent of their share grants if the Group's Return on Equity ('ROE') average is ten per cent over the three year performance period (the 'maximum target')
(iii) no grants will vest unless the Group's ROE average over the period equals or exceeds eight per cent at which point 40 per cent of the grant will vest (the 'minimum target')
(iv) a grant will vest on a straight-line basis if the Group's ROE average is between the minimum target and the maximum target.

Exercise of options granted prior to 22 June 2004 under the Option Schemes is dependent upon the basic earnings per share of the Group increasing at two per cent more than the rate of inflation over a period of three years.

The Remuneration Committee believes that using ROE as the long-term performance condition better aligns the interests of employees with shareholders because:

(i) ROE captures the efficiency with which the Company is using shareholder funds to generate earnings, whereas EPS growth gives no indication of the level of return on the investment required to generate those additional earnings
(ii) the Company operates in a highly cyclical business where earnings can fluctuate considerably, which can have a distorting effect on EPS growth. Where EPS is used as a performance condition this can introduce an element of luck as to when in the cycle share grants are made which can operate to the disadvantage of both employees and shareholders. The Remuneration Committee believes that an average ROE performance requirement over the three year period smoothes out the cyclical fluctuations in earnings and ensures that over any given period shareholders will receive a minimum return on equity before share grants to employees will vest.

The ROE will be calculated as profit before tax and goodwill amortisation divided by shareholders' funds at the beginning of each year. The ROE will be calculated for each of the three financial years constituting the performance period and then averaged.

The Remuneration Committee will review the ROE target attaching to grants on an annual basis in light of the prevailing bond yields and make adjustments to the target, provided that in the opinion of the Remuneration Committee the adjusted target shall be no easier to satisfy than the original target when imposed and provided that shareholders will be consulted in advance in respect of any material change.

The 2005 reviews resulted in the amendments to the rules of the Hiscox Unapproved Share Option Scheme by the addition of a new Schedule 2 so as to allow the grant of options to French employees that will qualify for favourable tax treatment in France ('Approved Options in France'). These were approved by shareholders on 21 June 2005.

## Pensions

The pension entitlement shown in the table below is that which would be paid annually on retirement based on service to the end of the year, with the exception of RRS Hiscox, whose figures below are based on his actual pension in payment. The increase in accrued pension for the year excludes any increase for inflation. The transfer value has been calculated on the basis of actuarial advice in accordance with version 8.1 Actuarial Guidance Note GN11: Retirement Benefit Schemes – Transfer Values. No contractual contributions were due or have been paid by the Directors during the year. RRS Hiscox retired from the scheme on 3 January 2003.

RS Childs left the Hiscox final salary pension scheme on 31 December 2005. Prior to this date the Company injected £670,000 to the pension scheme to augment RS Childs' pension entitlement. The Trustees of the Scheme agreed to this augmentation, after receiving legal and actuarial advice. RS Childs will no longer acquire any benefits under the final salary pension scheme.

## Pensions

| | Increase in accrued pension during the year £000 | Total accrued pension at 31 December 2005 £000 | Transfer value of increase in accrued pension £000 | Transfer value of accrued pension at 1 January 2005 £000 | Transfer value of accrued pension at 31 December 2005 £000 | Increase in transfer value of accrued benefit during the year £000 |
|---|---|---|---|---|---|---|
| RRS Hiscox | 8 | 177 | 203 | 4,105 | 4,388 | 283 |
| BE Masojada | 5 | 31 | 65 | 355 | 482 | 127 |
| RS Childs | 60 | 188 | 1,003 | 2,496 | 3,834 | 1,338 |
| SJ Bridges | 4 | 23 | 43 | 227 | 311 | 84 |

## Remuneration of Non Executive Directors

Non Executive Directors receive an annual fee in respect of their Board appointments together with additional compensation for their further duties in relation to Board committees. The fees are reviewed annually, but are not necessarily increased and are set by the Board to attract individuals with a broad range of relevant skills and experience. The Non Executive Directors receive no other benefits.

| | Hiscox plc Board £ | Subsidiary Board and Committees £ | Total 2005 £ | Total 2004 £ |
|---|---|---|---|---|
| SH Hall* | 30,000 | 17,500 | 47,500 | 47,500 |
| AGC Howland Jackson | 28,500 | 18,750 | 47,250 | 45,000 |
| DND Netherton | 28,500 | 13,250 | 41,750 | 40,000 |
| C Franklin Engler | 28,500 | 8,250 | 36,750 | 35,000 |
| AR Auer** | 14,250 | 5,375 | 19,625 | – |
| Sir Mervyn Pedelty** | 14,250 | 5,625 | 19,875 | – |

*SH Hall resigned with effect 31 December 2005.
**AR Auer and Sir Mervyn Pedelty were appointed with effect 1 July 2005.

## Executive Directors' service contracts

Directors' service contracts are on a rolling basis and the unexpired term shown in the following table is therefore the same as the notice period.

The Remuneration Committee believes that these notice periods provide an appropriate balance having regard to prevailing market conditions and current practice amongst public companies. No external appointment may be accepted by an Executive Director where it may give rise to a conflict of interest. The consent of the Chairman is required in any event.

None of the contracts include any provision for compensation payments on early termination.

| Director | Effective date of contract | Unexpired term and notice period |
|---|---|---|
| RRS Hiscox | 20 Dec 2002 | 12 months |
| BE Masojada | 1 Jan 1998 | 6 months |
| RS Childs | 1 Jan 1998 | 6 months |
| SJ Bridges | 1 Jan 1999 | 6 months |
| SH Hall* | 14 Dec 2004 | 3 months |
| AGC Howland Jackson | 14 Dec 2004 | 3 months |
| DND Netherton | 14 Dec 2004 | 3 months |
| C Franklin Engler | 14 Dec 2004 | 3 months |
| AR Auer | 1 Jul 2005 | 3 months |
| Sir Mervyn Pedelty | 1 Jul 2005 | 3 months |

*SH Hall resigned with effect 31 December 2005.

## External non executive directorships

During the year Robert Hiscox has been a Non Executive Director of Grainger Trust plc and is paid £25,000 for his services.

Bronek Masojada is Deputy Chairman of Lloyd's. Bronek is also a Non Executive Director of Ins-sure Holding Limited and its subsidiaries. The fees for his services are remitted to the Group, as disclosed in note 36.

Neither Stuart Bridges nor Robert Childs held Non Executive Director positions during the year.

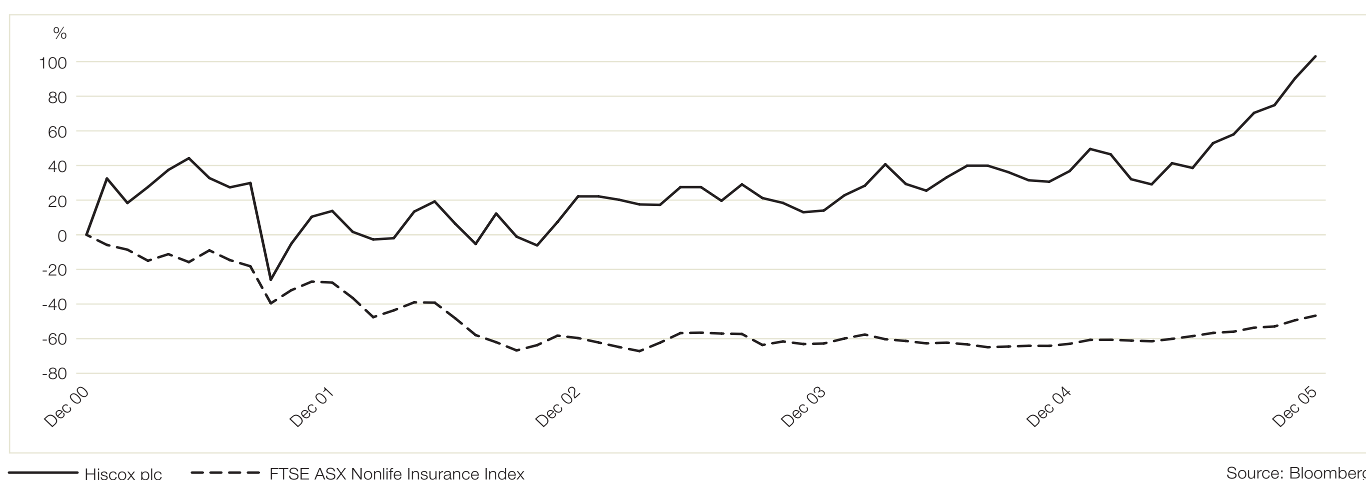
By order of the Board

SJ Bridges
*Secretary*
1 Great St Helen's
London EC3A 6HX
13 March 2006

## Remuneration of Executive Directors

The emoluments received by each person who served as an Executive Director during the year are set out below:

| | 2005 Basic salary/fees £000 | 2005 Benefits £000 | 2005 Bonus £000 | 2005 Total £000 | 2004 Basic salary/fees £000 | 2004 Benefits £000 | 2004 Bonus £000 | 2004 Total £000 |
|---|---|---|---|---|---|---|---|---|
| RRS Hiscox | 258 | 16 | 125 | 399 | 250 | 16 | 400 | 666 |
| BE Masojada | 309 | 15 | 175 | 499 | 286 | 15 | 475 | 776 |
| RS Childs | 291 | 18 | 150 | 459 | 262 | 18 | 575 | 855 |
| SJ Bridges | 249 | 14 | 150 | 413 | 216 | 14 | 300 | 530 |




The above graph shows the Company's performance, measured by total shareholder return, compared with the performance of the FTSE All-Share Insurance Index also measured by total shareholder return. The FTSE All-Share Insurance Index has been selected for this comparison because it is the most representative index for measuring the performance of the insurance market in which Hiscox participates.

# Directors' report

The Directors have pleasure in submitting their Annual Report and financial statements for the year ended 31 December 2005.

## Principal activity and business review

The Company is a holding company for subsidiaries involved in the business of insurance in the UK and overseas.

The review of the year and likely future developments are described further in the Chairman's statement and the report on Group financial performance.

## Financial results

The Group achieved a pre-tax profit for the year of £70.2 million (2004: £89.5 million). Detailed results for the year are shown in the consolidated income statement on page 50.

## Dividends

An interim dividend of 2.25p (net) per share (2004: 1.5p (net)) was paid on 24 October 2005 in respect of the year ended 31 December 2005. The Directors recommend the payment of a final dividend of 4.75p (net) per share (2004: 3.5p (net)). If approved this will be paid on 26 June 2006 to shareholders on the register at the close of business on 21 April 2006.

## Directors

The names and details of the individuals who served as Directors of the Company during the year (including those offering themselves for re-election) are set out on pages 4 and 5. Stephen Hall was the Senior Independent Director during the year under review but retired on 31 December 2005. Anthony Howland Jackson succeeded him as the Senior Independent Director on 1 January 2006. The Board are grateful for the significant contribution that Stephen Hall has made to the Group's development.

Adrian Auer and Sir Mervyn Pedelty were both appointed as Non Executive Directors on 1 July 2005 to continue to maintain the balance of a strong non executive team. Adrian Auer has recent experience as the Group Finance Director of a public company. Sir Mervyn Pedelty has recent experience as the Chief Executive of a public company in the financial services sector and the Board believes this will be especially valuable in discussions of Group strategy.

In accordance with the Articles of Association and Combined Code, Robert Hiscox, Anthony Howland Jackson and Derek Netherton will retire at the Annual General Meeting and, being eligible, offer themselves for re-election as Directors. Adrian Auer and Sir Mervyn Pedelty were appointed as Directors since the previous Annual General Meeting and therefore stand for appointment as Directors. Following formal performance evaluation, the individuals are considered to be effective and have demonstrated commitment to their respective roles.

The Company provides Directors and Officers' insurance for all of its Directors. The Directors have the benefit of "qualifying third party indemnity provisions" for the purposes of sections 309A to 309C of the Companies Act 1985 pursuant to the Company's Articles of Association. A copy of the Articles of Association is available for inspection at the Company's registered office.

## Going concern

After making enquiries, the Directors have a reasonable expectation that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the accounts.

## Corporate social responsibility

The Board takes regular account of the significance of social, environmental and ethical ('SEE') matters to the business of the Company and has identified and assessed the significant risks to the Company's short and long-term value arising from such matters, and has considered any potential to enhance value by responding to the issues appropriately.

The Board confirms it has received adequate information to assess SEE issues and that appropriate training is available to Directors should they request it.

The Board recognises the potential impact of socio-economic issues upon the short and long-term value of the Company. The Head of Risk oversees the risk management framework through which the business units report relevant risks to the Board and Audit Committee throughout each year.

## Directors' interests

| | 31 December 2005 5p ordinary shares Number of shares beneficial | 31 December 2005 5p ordinary shares Number of shares non-beneficial | 31 December 2004 5p ordinary shares Number of shares beneficial | 31 December 2004 5p ordinary shares Number of shares non-beneficial |
|---|---|---|---|---|
| Executive Directors | | | | |
| RRS Hiscox | 9,382,500 | 580,237 | 8,912,059 | 567,715 |
| BE Masojada | 2,702,902 | – | 2,359,455 | – |
| RS Childs | 1,382,067 | – | 1,173,468 | – |
| SJ Bridges | 460,877 | – | 286,363 | – |
| Non Executive Directors | | | | |
| SH Hall* | 45,500 | – | 35,500 | – |
| AGC Howland Jackson | 65,804 | – | 49,589 | – |
| DND Netherton | 19,905 | – | 15,000 | – |
| C Franklin Engler | 17,550 | – | 17,550 | – |
| AR Auer | – | – | N/A | N/A |
| Sir Mervyn Pedelty | – | – | N/A | N/A |

*SH Hall resigned with effect 31 December 2005.

Hiscox Trustees Limited is the trustee of the Hiscox plc Group Employee Share Ownership Plan Trust ('the ESOP') and is interested in 135,782 ordinary shares in the Company. The Executive Directors are potential beneficiaries of the ESOP and are therefore each deemed to have an interest in the Hiscox shares owned by Hiscox Trustees Limited, the trustee of the ESOP.

The Directors have not dealt in any securities of the Company between 31 December 2005 and the date of approval of these Report and Accounts.

Details of Directors' interests in share options are set out on pages 95 to 96.

## Political and charitable contributions

The Group made no political contributions during the year (2004: £nil). Charitable donations totalled £78,650 (2004: £78,300) of which £50,000 (2004: £50,000) was donated to the Hiscox Foundation, a UK registered charity. The policy of the Hiscox Foundation is to assist and improve education, the arts and independent living for disabled and disadvantaged members of society. Further information concerning the Group's charitable activities is contained in the report on Corporate responsibility on pages 36 to 37.

## Payment of creditors

It is the policy of the Group to agree terms of payment for its business transactions with its suppliers and ensure that the supplier is aware of the terms of payment.

Payment is then made on these terms, subject to the other terms and conditions being met by the supplier. The Group had 17.1 (2004: 15.4) days' purchases outstanding at 31 December 2005 based on the average daily amount invoiced by suppliers during the year ended 31 December 2005. The Company is a holding company and accordingly has no days' purchases outstanding at 31 December 2005. Therefore, the Group creditors' days are considered to be more representative. The Group does not follow a specific code with regard to the payment of creditors.

## Major interests in shares

The Company has been notified of the following shareholdings of three per cent or more in the ordinary shares of the Company as at 13 March 2006:

| | Number of shares | % of total |
|---|---|---|
| Amvescap plc | 62,255,281 | 15.9 |
| Fidelity International Limited | 33,515,451 | 8.5 |
| Barclays plc | 14,330,810 | 3.7 |
| Legal & General Group plc | 14,187,498 | 3.6 |
| Morley Fund Management Limited | 13,476,468 | 3.4 |

## Adoption of International Financial Reporting Standards

In accordance with European Union ('EU') law (IAS Regulation EC 1606/2002), the consolidated financial statements included in this report have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as adopted by the EU. This is the first year that the Group has adopted IFRSs as the basis for reporting its consolidated results.

In addition, the individual accounts of the parent company have also been prepared for the first occasion in accordance with IFRSs as adopted by the EU, as permitted by Statutory Instrument 2004 No. 2947 'The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004'.

## Annual General Meeting

The notice of the Annual General Meeting is contained on pages 102 and 103. In addition to the ordinary business, the following items of special business will be considered at the meeting.

Resolution 10, which will be proposed as an ordinary resolution, seeks to obtain approval for the remuneration report as set out on pages 41 to 43 of this Report and Accounts.

Resolution 11, which will be proposed as an ordinary resolution, seeks to renew the Directors' authority to allot relevant securities pursuant to Section 80 of the Companies Act 1985. The authority contained in the resolution will be limited to the allotment of relevant securities to an aggregate nominal value of £6,533,231.86 representing 33.3 per cent of the issued ordinary share capital as at 13 March 2006. This authority will terminate no later than the earlier of the conclusion of the next Annual General Meeting or a date falling 15 months after the date of the passing of the resolution. The Directors presently have no intention of exercising this authority.

Resolution 12, which will be proposed as a special resolution, seeks to renew the authority conferred on the Board to issue equity securities of the Company for cash without application of pre-emption rights as provided by Section 89 of the Companies Act 1985. The authority contained in this resolution will be limited to an aggregate nominal value of £979,984.78, representing 5.0 per cent of the issued ordinary share capital as at 13 March 2006. This authority will terminate no later than the earlier of the conclusion of the next Annual General Meeting or a date falling 15 months after the date of the passing of the resolution.

Resolution 13, which will be proposed as a special resolution, seeks to obtain authority for the Company to repurchase its own shares from the market. In certain circumstances, it may be advantageous for the Company to purchase its own shares pursuant to Section 166 of the Companies Act 1985. The Directors intend to exercise this authority only where they believe that a purchase would be the best use of the Company's resources, result in an increased earnings per share and is in the best interests of the Company's shareholders as a whole.

Any ordinary shares purchased pursuant to this authority may either be held as treasury shares or cancelled by the Company, depending on which course of action is considered by the Directors to be in the best interests of the shareholders at the time.

The authority contained in the resolution will be limited to a purchase of own shares up to a maximum number of 19,500,000 shares, representing 4.97 per cent of the issued capital of the Company as at 13 March 2006, and the price to be paid for the shares will be limited to a minimum share price of £0.50 per share and a maximum price per share that is not more than five per cent above the average of the closing middle market quotations for an ordinary share as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the date on which the ordinary share is purchased. This authority will terminate on the earlier of the conclusion of the next Annual General Meeting or a date falling 15 months after the date of the passing of the resolution.

The total number of options to subscribe for ordinary shares that were outstanding as at 13 March 2006 was 18,503,779 which represented 4.7 per cent of the issued share capital as at that date (which represents 5.0 per cent of the Company's issued share capital if the authority to purchase shares under the resolution is used in full). There are no warrants.

Save to the extent purchased pursuant to the Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003 (the 'Regulations'), any shares purchased under this resolution will be cancelled. Shares purchased by the Company pursuant to the Regulations may be subsequently transferred to an employees' share scheme, and such transfers will not exceed five per cent of the issued ordinary share capital of the Company (adjusted for scrip/bonus and Rights Issues) in any rolling ten year period. The Company does not currently hold any treasury shares. Hiscox Holdings Limited and Hiscox Trustees Limited, subsidiaries of the Company, own 54,560 and 135,782 shares respectively in the Company at 13 March 2006.

Your Directors consider that each of the resolutions described above and in the notice of Annual General Meeting will be of benefit to and is in the best interest of the Company and shareholders as a whole. Your Directors unanimously recommend that you vote in favour of the resolutions. Those Directors who hold ordinary shares in the Company intend to do so in respect of their own beneficial holdings, except with regard to Resolution 10 (relating to the remuneration report) on which they will not vote.

By order of the Board

SJ Bridges
*Secretary*
1 Great St Helen's, London EC3A 6HX
13 March 2006

# Statement of Directors' responsibilities

The Directors are responsible for preparing the Annual Report and the Group and parent Company financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare Group and parent Company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and have elected to prepare the parent Company financial statements on the same basis.

The Group and parent Company financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the Group and the parent Company and the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the Group and parent Company financial statements, the Directors are required to:

(a) select suitable accounting policies and then apply them consistently

(b) make judgments and estimates that are reasonable and prudent

(c) state whether they have been prepared in accordance with IFRSs as adopted by the EU

(d) prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent Company will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent Company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the Directors are also responsible for preparing a Directors' report, Directors' remuneration report and the Corporate governance statement that comply with that law and those regulations.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Independent auditors' report to the shareholders of Hiscox plc

We have audited the Group and Company financial statements (the 'financial statements') of Hiscox plc for the year ended 31 December 2005 which comprise the Consolidated income statement, the Consolidated and Company balance sheets, the Consolidated and Company cash flow statements, the Consolidated and Company statements of changes in equity and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' remuneration report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

## Respective responsibilities of Directors and auditors

The Directors' responsibilities for preparing the Annual Report, the Directors' remuneration report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU are set out in the Statement of Directors' responsibilities on page 48.

Our responsibility is to audit the financial statements and the part of the Directors' remuneration report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the financial statements, Article 4 of the IAS regulation. We also report to you if, in our opinion, the Directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We review whether the Corporate governance statement reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

## Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgments made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' remuneration report to be audited.

## Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2005 and of the Group's profit for the year then ended
- the Company financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Act 1985, of the state of the Company's affairs as at 31 December 2005
- the financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the financial statements, Article 4 of the IAS Regulation.

KPMG Audit Plc
Chartered Accountants
Registered Auditor
London
13 March 2006

# Consolidated income statement
## For the year ended 31 December 2005

| | Notes | 2005 £000 | 2004 £000 |
|---|---|---|---|
| Income | | | |
| Gross premiums written | 5 | 861,174 | 816,609 |
| Outward reinsurance premiums | | (179,938) | (112,524) |
| Net premiums written | 5 | 681,236 | 704,085 |
| Insurance premiums earned | | 879,344 | 847,524 |
| Insurance premiums ceded to reinsurers | | (186,045) | (132,672) |
| Net premiums earned | 5 | 693,299 | 714,852 |
| Investment result | 7 | 43,883 | 35,806 |
| Other income | 10 | 81,297 | 15,112 |
| Net revenue | | 818,479 | 765,770 |
| Expenses | | | |
| Claims and claim adjustment expenses, net of reinsurance | 25 | (457,025) | (382,063) |
| Expenses for the acquisition of insurance contracts | 9 | (199,979) | (177,960) |
| Administration expenses | | (41,197) | (43,198) |
| Other operating expenses | 10 | (46,973) | (71,440) |
| Total expenses | | (745,174) | (674,661) |
| Results of operating activities | | 73,305 | 91,109 |
| Finance costs | 12 | (3,334) | (1,977) |
| Share of profit of associates | 17 | 250 | 390 |
| Profit before tax | | 70,221 | 89,522 |
| Tax expense | 27 | (21,591) | (25,574) |
| Profit for the year (all attributable to equity shareholders of the Company) | | 48,630 | 63,948 |
| Earnings per share on profit attributable to equity shareholders of the Company | | | |
| Basic | 30 | 15.6p | 21.3p |
| Diluted | 30 | 15.1p | 21.0p |

# Consolidated balance sheet
## At 31 December 2005

| | Notes | 2005 £000 | 2004 £000 |
|---|---|---|---|
| Assets | | | |
| Intangible assets | 16 | 33,099 | 29,989 |
| Property, plant and equipment | 15 | 12,128 | 10,691 |
| Investments in associates | 17 | 18 | 1,109 |
| Deferred acquisition costs | 9 | 106,747 | 109,970 |
| Financial assets | 19 | 1,237,778 | 980,731 |
| Loans and receivables including insurance receivables | 20 | 436,981 | 327,482 |
| Reinsurance contract receivables | 18, 25 | 506,376 | 238,871 |
| Cash and cash equivalents | 22 | 413,759 | 119,563 |
| Total assets | | 2,746,886 | 1,818,406 |
| Equity and liabilities | | | |
| Shareholders' equity | | | |
| Share capital | 23 | 19,570 | 14,685 |
| Share premium | 23 | 401,365 | 234,267 |
| Other reserves | 24 | 38,789 | 37,499 |
| Retained earnings | 24 | 118,289 | 82,375 |
| Total equity | | 578,013 | 368,826 |
| Employee retirement benefit obligations | 29 | 16,677 | 34,718 |
| Deferred tax | 28 | 15,193 | 14,517 |
| Insurance contracts | 25 | 1,723,000 | 1,246,903 |
| Financial liabilities | 19 | 126,246 | 57 |
| Current tax | | 16,581 | 7,855 |
| Trade and other payables | 26 | 271,176 | 145,530 |
| Total liabilities | | 2,168,873 | 1,449,580 |
| Total equity and liabilities | | 2,746,886 | 1,818,406 |

The consolidated Group financial statements were approved by the Board of Directors on 13 March 2006 and signed on its behalf by:

RRS Hiscox
*Chairman*

SJ Bridges
*Group Finance Director*

# Company balance sheet
## At 31 December 2005

| | Notes | 2005 £000 | 2004 £000 |
|---|---|---|---|
| Assets | | | |
| Property, plant and equipment | 15 | 3,709 | 3,571 |
| Investment in subsidiary undertakings | 19 | 406,997 | 115,457 |
| Investment in associate | 17 | 18 | 200 |
| Deferred tax | 28 | 2,089 | – |
| Financial assets | 19 | 144,945 | 137,582 |
| Current tax assets | | 3,238 | – |
| Loans and receivables | 20 | 158,334 | 175,652 |
| Prepayments and accrued income | | 1,104 | 982 |
| Cash and cash equivalents | 22 | 11,945 | 5,183 |
| Total assets | | 732,379 | 438,627 |
| Equity and liabilities | | | |
| Shareholders' equity | | | |
| Share capital | 23 | 19,570 | 14,685 |
| Share premium | 23 | 401,365 | 234,267 |
| Other reserves | 24 | 92,214 | 92,214 |
| Retained earnings | 24 | 26,369 | 18,631 |
| Total equity | | 539,518 | 359,797 |
| Employee retirement benefit obligations | 29 | 16,677 | 34,718 |
| Deferred tax | 28 | – | 2,018 |
| Financial liabilities | 19 | 125,986 | – |
| Current tax | | – | 614 |
| Trade and other payables | 26 | 50,198 | 41,480 |
| Total liabilities | | 192,861 | 78,830 |
| Total equity and liabilities | | 732,379 | 438,627 |

The Company financial statements were approved by the Board of Directors on 13 March 2006 and signed on its behalf by:

RRS Hiscox
*Chairman*

SJ Bridges
*Group Finance Director*

# Consolidated statement of changes in equity

| | Notes | Share capital £000 | Share premium £000 | Merger reserve £000 | Currency translation reserve £000 | Capital redemption reserve £000 | Retained earnings £000 | Total £000 |
|---|---|---|---|---|---|---|---|---|
| Balance at 1 January 2004 | | 14,565 | 232,341 | 4,723 | – | 33,244 | 29,812 | 314,685 |
| Currency translation differences | 24 | – | – | – | (468) | – | – | (468) |
| Net income/(expenses) recognised directly in equity | | – | – | – | (468) | – | – | (468) |
| Profit for the year | | – | – | – | – | – | 63,948 | 63,948 |
| Total recognised income for year | | – | – | – | (468) | – | 63,948 | 63,480 |
| Employee share options: | | | | | | | | |
| Equity settled share based payments | | – | – | – | – | – | 1,194 | 1,194 |
| Proceeds from shares issued | 23 | 120 | 1,926 | – | – | – | – | 2,046 |
| Change in own shares | | – | – | – | – | – | 254 | 254 |
| Dividends to shareholders | 32 | – | – | – | – | – | (12,833) | (12,833) |
| Balance at 31 December 2004 | | 14,685 | 234,267 | 4,723 | (468) | 33,244 | 82,375 | 368,826 |
| Currency translation differences | 24 | – | – | – | 1,290 | – | – | 1,290 |
| Net income/(expenses) recognised directly in equity | | – | – | – | 1,290 | – | – | 1,290 |
| Profit for the year | | – | – | – | – | – | 48,630 | 48,630 |
| Total recognised income for year | | – | – | – | 1,290 | – | 48,630 | 49,920 |
| Employee share options: | | | | | | | | |
| Equity settled share based payments | | – | – | – | – | – | 2,059 | 2,059 |
| Deferred tax release on share based payments | | – | – | – | – | – | 1,950 | 1,950 |
| Proceeds from shares issued | 23 | 67 | 1,522 | – | – | – | – | 1,589 |
| Rights Issue of equity shares | 23 | 4,818 | 171,550 | – | – | – | – | 176,368 |
| Expenses related to Rights Issue of equity shares | 23 | – | (5,974) | – | – | – | – | (5,974) |
| Change in own shares | | – | – | – | – | – | 192 | 192 |
| Dividends to shareholders | 32 | – | – | – | – | – | (16,917) | (16,917) |
| Balance at 31 December 2005 | | 19,570 | 401,365 | 4,723 | 822 | 33,244 | 118,289 | 578,013 |

# Company statement of changes in equity

| | Notes | Share capital £000 | Share premium £000 | Merger reserve £000 | Capital redemption reserve £000 | Retained earnings £000 | Total £000 |
|---|---|---|---|---|---|---|---|
| Balance at 1 January 2004 | | 14,565 | 232,341 | 58,970 | 33,244 | 7,441 | 346,561 |
| Profit for the year | | – | – | – | – | 22,836 | 22,836 |
| Total recognised income for the year | | – | – | – | – | 22,836 | 22,836 |
| Employee share options: | | | | | | | |
| Equity settled share based payments | | – | – | – | – | 1,194 | 1,194 |
| Proceeds from shares issued | 23 | 120 | 1,926 | – | – | – | 2,046 |
| Dividends to shareholders | 32 | – | – | – | – | (12,840) | (12,840) |
| Balance at 31 December 2004 | | 14,685 | 234,267 | 58,970 | 33,244 | 18,631 | 359,797 |
| Profit for the year | | – | – | – | – | 22,596 | 22,596 |
| Total recognised income for the year | | – | – | – | – | 22,596 | 22,596 |
| Employee share options: | | | | | | | |
| Equity settled share based payments | | – | – | – | – | 2,059 | 2,059 |
| Proceeds from shares issued | 23 | 67 | 1,522 | – | – | – | 1,589 |
| Rights Issue of equity shares | 23 | 4,818 | 171,550 | – | – | – | 176,368 |
| Expenses related to Rights Issue of equity shares | 23 | – | (5,974) | – | – | – | (5,974) |
| Dividends to shareholders | 32 | – | – | – | – | (16,917) | (16,917) |
| Balance at 31 December 2005 | | 19,570 | 401,365 | 58,970 | 33,244 | 26,369 | 539,518 |

# Cash flow statement
For the year ended 31 December 2005

## Consolidated Group

| | Notes | 2005 £000 | 2004 £000 |
|---|---|---|---|
| Profit before tax | | 70,221 | 89,522 |
| Interest received | | (46,844) | (33,069) |
| Net (gains)/losses on financial assets | | 4,289 | 593 |
| Retirement benefit charges in excess of contributions paid | | (18,041) | 1,384 |
| Depreciation | 15 | 3,281 | 2,934 |
| Charges in respect of share based payments | 11 | 2,059 | 1,194 |
| Other non-cash charges | | 690 | 1,302 |
| Changes in operational assets and liabilities: | | | |
| Insurance and reinsurance contracts | | 212,462 | 193,591 |
| Financial assets | | (256,280) | (230,913) |
| Other assets and liabilities | | 13,048 | (19,469) |
| Cash generated from operations | | (15,115) | 7,069 |
| Interest received | | 46,844 | 33,069 |
| Interest paid | | (2,573) | (1,409) |
| Current tax paid | | (10,239) | (206) |
| Net cash flows from operating activities | | 18,917 | 38,523 |
| Cash flows from the acquisition and sale of subsidiaries and associates | | 3,750 | (1,091) |
| Cash flows from the sale/(purchase) of property, plant and equipment | | (4,474) | (5,565) |
| Cash flows from the purchase of intangible assets | 16 | (3,277) | (3,406) |
| Loans repaid by related parties | 36 | 1,580 | 320 |
| Net cash used in investing activities | | (2,421) | (9,742) |
| Proceeds from the issue of ordinary shares | | 171,983 | 2,046 |
| Net cash flows from transactions in own shares | | 192 | 254 |
| Dividends paid to Company's shareholders | 32 | (16,917) | (12,833) |
| Proceeds from borrowings | | 121,133 | – |
| Repayments of borrowings | | (102) | (521) |
| Net cash flows from financing activities | | 276,289 | (11,054) |
| Net increase in cash and cash equivalents | | 292,785 | 17,727 |
| Cash and cash equivalents at 1 January | | 119,563 | 102,712 |
| Net increase in cash and cash equivalents | | 292,785 | 17,727 |
| Effect of exchange rate fluctuations on cash and cash equivalents | | 1,411 | (876) |
| Cash and cash equivalents at 31 December | 22 | 413,759 | 119,563 |

The purchase, maturity and disposal of financial assets is part of the Group's insurance activities and is therefore classified as an operating cash flow.

Included within cash and cash equivalents held by the Group are balances totalling £50,313,000 (2004: £35,835,000) not available for use by the Group which are held within the Lloyd's Syndicate.

# Cash flow statement
For the year ended 31 December 2005

## Company

| | Notes | 2005 £000 | 2004 £000 |
|---|---|---|---|
| Profit before tax | | 19,433 | 25,605 |
| Interest received | | (6,015) | (5,676) |
| Net (gains)/losses on financial assets | | 2,974 | (2,369) |
| Depreciation | 15 | 40 | 40 |
| Other non-cash charges | | 1,731 | – |
| Changes in operational assets and liabilities: | | | |
| Financial assets | | (5,281) | (35,827) |
| Other assets and liabilities | | 8,490 | 14,054 |
| Cash generated from operations | | 21,372 | (4,173) |
| Interest received | | 6,015 | 5,676 |
| Interest paid | | (711) | – |
| Current tax paid | | (3,899) | – |
| Net cash flows from operating activities | | 22,777 | 1,503 |
| Cash flows from the acquisition and sale of subsidiaries and associates | | (291,540) | (200) |
| Cash flows from the sale/(purchase) of property, plant and equipment | | (14) | (3,019) |
| Net cash used in investing activities | | (291,554) | (3,219) |
| Proceeds from the issue of ordinary shares | | 171,983 | 2,046 |
| Dividends paid to Company's shareholders | 32 | (16,917) | (12,840) |
| Proceeds from borrowings | 19 | 120,930 | – |
| Net cash flows from financing activities | | 275,996 | (10,794) |
| Net increase/(decrease) in cash and cash equivalents | | 7,219 | (12,510) |
| Cash and cash equivalents at 1 January | | 5,183 | 17,693 |
| Net movement in cash and cash equivalents | | 7,219 | (12,510) |
| Effect of exchange rate fluctuations on cash and cash equivalents | | (457) | – |
| Cash and cash equivalents at 31 December | 22 | 11,945 | 5,183 |

The purchase, maturity and disposal of financial assets is part of the Company's operating activities and is therefore classified as an operating cashflow.

# Notes to the financial statements

## 1 General information

The Hiscox Group, which is headquartered in London, United Kingdom, comprises Hiscox plc (the parent Company, referred to herein as the "Company") and its subsidiaries (collectively, the Hiscox Group or the "Group"). The Group provides insurance, reinsurance and investment management services to its clients worldwide. It has operations in the UK, Europe, USA and Bermuda and employs over 600 people worldwide.

Hiscox plc is a public limited company incorporated and domiciled in Great Britain under the Companies Act 1985. The address of the registered office is 1 Great St Helen's, London, EC3A 6HX.

The consolidated financial statements of the Company for the year ended 31 December 2005 comprise all of the Group's subsidiary companies and the Group's interest in associates. All amounts relate to continuing operations.

The financial statements were authorised for issue by the Directors on 13 March 2006.

## 2 Significant accounting policies

The principal accounting policies applied in the preparation of these consolidated Group and Company financial statements are set out below.

### 2.1 Statement of compliance

These consolidated Group and Company financial statements have been prepared in accordance with International Financial Reporting Standards as adopted by the EU and in accordance with the provisions of the Companies Act 1985. The Company has also applied the provisions of Statutory Instrument 2004 No. 2947 "The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004."

Since 2002, the standards adopted by the IASB have been referred to as 'International Financial Reporting Standards' (IFRSs). The standards from prior years continue to bear the title 'International Accounting Standards' (IASs). Insofar as a particular standard is not explicitly referred to, the two terms are used in these financial statements synonymously.

These are the Group and Company's first financial statements prepared in accordance with IFRSs as adopted by the EU. The disclosures required by IFRS 1 *First-time Adoption of International Financial Reporting Standards* concerning the transition from UK GAAP to IFRSs, and its effect on the reported financial position, financial performance and cash flows, are given in note 3.

The Group and Company have taken advantage of the following exemptions set out in IFRS 1:

- IFRS 3 *Business Combinations* has not been applied retrospectively to business combinations that occurred before 1 January 2004. Accumulated amortisation on goodwill arising before 1 January 2004 has not, therefore, been reversed
- all cumulative actuarial gains and losses arising on employee benefit schemes to 1 January 2004 have been recognised in equity at 1 January 2004
- cumulative translation differences for all foreign operations are deemed to be zero at 1 January 2004
- the provisions of IFRS 2 *Share-based payment* to exclude equity settled awards granted on or before 7 November 2002, or to awards granted after that date but vesting prior to 1 January 2005.

The Group and the Company have not availed themselves of the exemptions within IFRS 1 that allow comparative information presented in the first year of adoption of IFRSs not to comply with IAS 32 *Financial Instruments: Disclosure and Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 4 *Insurance Contracts*.

The Group has elected to apply the transitional arrangements contained in IFRS 4 that permit the disclosure of only five years of data in claims development tables, in the year of adoption. The number of years of data presented will be increased in each succeeding additional year, up to a maximum of ten years, if material outstanding claims exist for such periods.

In March 2004, the IASB issued IFRS 4 *Insurance Contracts* which specifies the financial reporting for insurance contracts by an insurer. The standard is only the first phase in the IASB's insurance contract project and as such is only a stepping stone to phase II, introducing limited improvements to accounting for insurance contracts. Accordingly, to the extent that IFRS 4 does not specify the recognition or measurement of insurance contracts, transactions reported in these consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the UK.

### 2.2 Basis of preparation

The financial statements are presented in Pounds Sterling and are rounded to the nearest thousand. They are prepared on the historical cost basis except that ownership interests held in financial assets and liabilities, and derivative financial instruments, are recorded at fair value through profit or loss.

The accounting policies set out below have been applied consistently to all periods presented in these consolidated Group and Company financial statements and in preparing an opening balance sheet at 1 January 2004 for the purposes of the transition to IFRSs as adopted by the EU.

The accounting policies have been applied consistently by all Group entities solely for the purpose of producing the consolidated Group and Company financial statements.

The Company has taken advantage of the exemption provided under Section 230 of the Companies Act 1985 not to publish its individual income statement and related notes. The profit after taxation for the Company for the year was £22,596,000 (2004: £22,836,000).

The Directors have considered recently published IFRSs, new interpretations and amendments to existing standards that are mandatory to the Group and Company's accounting periods commencing on or after 1 January 2006 and which have not been subject to early adoption. The main developments that are expected to be of relevance to forthcoming financial years are:

- IAS 39 (*Amendment), the Fair Value Option (effective 1 January 2006).* The Directors believe that this amendment should not have a significant impact as the Company and the Group should be able to comply with the amended criteria for continuing the designation of financial instruments at fair value through profit or loss
- IFRS 7 *Financial Instruments: Disclosures*, and a complementary amendment to IAS 1 *Presentation of Financial Statements – Capital Disclosures (effective 1 January 2007).* IFRS 7 introduces additional minimum disclosure requirements regarding exposures to risk arising from financial instruments. The amendment to IAS 1 introduces minimum disclosures about the level of an entity's capital and how it manages that capital. The Directors' current assessment is that the main additional disclosures arising from the application of these developments from 1 January 2007 will be more detailed sensitivity analysis to market risk, and additional capital management disclosures.

### 2.3 Basis of consolidation

*(a) Subsidiaries*

Subsidiaries are those entities controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights

that are currently exercisable or convertible are taken into account. The consolidated financial statements include the assets, liabilities and results of the Company and subsidiaries up to 31 December each year. The financial statements of subsidiaries are included in the consolidated financial statements only from the date that control commences until the date that control ceases.

Hiscox Dedicated Corporate Member Limited and the subsidiaries of Hiscox Select Holdings Limited underwrite as corporate members of Lloyd's on the syndicate managed by Hiscox Syndicates Limited (the 'managed syndicate'). In view of the several but not joint liability of underwriting members at Lloyd's for the transactions of syndicates in which they participate, the Group's attributable share of the transactions, assets and liabilities of the syndicate has been included in the financial statements.

The Group uses the purchase method of accounting to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement. The Company recognises all investments in Group undertakings at cost less provisions for impairment in value.

*(b) Associates*
Associates are those entities in which the Group or the Company has significant influence but not control over the financial and operating policies. The consolidated financial statements include the Group or the Company's share of the total recognised gains and losses of associates on an equity accounted basis from the date that significant influence commences until the date that significant influence ceases. The Company and the Group's share of its associates' post-acquisition profits or losses after tax is recognised in the income statement each period, and its share of the movement in the associates' net assets is reflected in the investments' carrying values in the balance sheet. When the Company or Group's share of losses equals or exceeds the carrying amount of the associate, the carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Company or the Group has incurred obligations in respect of the associate.

*(c) Transactions eliminated on consolidation*
Intragroup balances, transactions and any unrealised gains arising from intragroup transactions are eliminated in preparing the consolidated financial statements. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred.

Unrealised gains arising from transactions with associates and jointly controlled entities are eliminated to the extent of the Group's interest in the entity. Unrealised gains arising from transactions in associates are eliminated against the investment in the associate.

## 2.4 Foreign currency translation

*(a) Functional and presentational currency*
Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The functional currency of all individual entities in the Group is deemed to be Sterling with the exception of the entities operating in France, Germany, the Netherlands and Belgium whose functional currency is Euros, those entities operating from the USA and Bermuda whose functional currency is US Dollars, and Hiscox Insurance Company (Guernsey) Limited whose functional currency is also US Dollars.

*(b) Transactions and balances*
Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the retranslation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as qualifying net investment hedges.

*(c) Group companies*
The results and financial position of all the Group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

(i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet

(ii) income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the date of the transactions)

(iii) all resulting exchange differences are recognised as a separate component of equity.

When a foreign operation is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as the foreign entity's assets and liabilities and are translated at the closing rate.

## 2.5 Property, plant and equipment

Property, plant and equipment are stated at historical cost less depreciation and any recognised impairment loss. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group or the Company and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

Land and Artwork assets are not depreciated as they are deemed to have an indefinite useful economic life. Depreciation on other assets is calculated using the straight-line method to allocate their cost or revalued amounts to their residual values over their estimated useful lives, as follows:

| | |
|---|---|
| – Buildings | 50 years |
| – Vehicles | 3 years |
| – Short leasehold fixtures and fittings | 10-15 years |
| – Furniture, fittings and equipment | 3-15 years |

The assets' residual values and useful lives are reviewed at each balance sheet date and adjusted if appropriate.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the income statement.

2.6 Intangible assets

*(a) Goodwill*

Goodwill represents amounts arising on acquisition of subsidiaries, associates and joint ventures. In respect of acquisitions that have occurred since 1 January 2004, goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary or associate at the acquisition date.

In respect of acquisitions prior to this date, goodwill is included on the basis of its deemed cost, which represents the amount recorded under previous GAAP.

Goodwill on acquisition of subsidiaries is included in intangible assets. Goodwill on acquisition of associates is included in investments in associates. Goodwill is not amortised but is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment review process examines whether or not the carrying value of the goodwill attributable to individual cash generating units exceeds its implied value. Any excess of goodwill over implied value indicates impairment.

Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

*(b) Syndicate capacity*

The cost of purchasing the Group's participation in the Lloyd's insurance syndicates is not amortised but is tested annually for impairment and is carried at cost less accumulated impairment losses. Having considered the future prospects of the London insurance market, the Board believe that the Group's ownership of syndicate capacity will provide economic benefits over an indefinite number of future periods.

*(c) Rights to customer contractual relationships*

Costs directly attributable to securing rights to customer contract relationships are recognised as an intangible asset where they can be identified separately and measured reliably and it is probable that they will be recovered by directly related future profits. These costs are amortised over the useful economic life which is deemed to be 20 years and are carried at cost less accumulated amortisation and impairment losses.

*(d) Computer software*

Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring into use the specific software. These costs are amortised over the expected useful life of the software of three years on a straight line basis.

Internally developed computer software is only capitalised where the cost can be measured reliably. The Group intends to and has adequate resources to complete development and where the computer software will yield future economic benefits in excess of the costs incurred.

2.7 Investments

The Group and the Company have classified financial investments as a) financial assets designated at fair value through profit or loss, and b) loans and receivables. The accounting policies for investments in subsidiaries and associated enterprises are set out at note 2.3 above. Management determines the classification of its financial investments at initial recognition and re-evaluates this at every reporting date. The decision by the Group and the Company to designate all financial investments at fair value through the income statement reflects the fact that the investment portfolios are managed, and their performance evaluated, on a fair value basis. Regular purchases and sales of investments are accounted for at the date of trade.

Fair value for securities quoted in active markets is the bid price. For instruments where no active market exists, fair value is determined by referring to recent transactions and other valuation factors including the discounted value of expected future cash flows. Fair value changes are recognised immediately within the investment result line in the income statement.

*(a) Financial assets at fair value through income*

A financial asset is classified into this category at inception if acquired principally for the purpose of selling in the short-term, if it forms part of a portfolio of financial assets in which there is evidence of short-term profit taking, or if so designated by management.

*(b) Loans and receivables*

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted on an active market. Receivables arising from insurance contracts are also classified in this category and are reviewed for impairment as part of the impairment review of loans and receivables. Loans and receivables are carried at cost less any provision for impairment in value.

2.8 Cash and cash equivalents

The Group and the Company have classified cash deposits and short-term highly liquid investments as cash and cash equivalents. These assets are readily convertible into known amounts of cash and are subject to inconsequential changes in value. Cash equivalents are financial investments with less than three months to maturity at the date of acquisition.

2.9 Impairment of assets

Assets that have an indefinite useful life are not subject to amortisation and are tested annually or whenever there is an indication of impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units).

2.10 Derivative financial instruments

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently valued at their fair value at each balance sheet date. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged. For derivatives not designated as a hedging instrument, fair value changes are recognised immediately in the income statement. The Group and the Company had no financial instruments designated for hedge accounting during the current and prior financial year.

2.11 Own shares

Where any Group company purchases the parent Company's equity share capital (own shares), the consideration paid, including any directly attributable incremental costs (net of income taxes), is deducted from equity attributable to the Company's equity holders. Where such shares are subsequently sold, reissued or otherwise disposed of, any consideration received is included in equity attributable to the Company's equity holders, net of any directly attributable incremental transaction costs and the related income tax effects.

2.12 Net revenue

Net revenue comprises insurance premiums earned, net of reinsurance, together with profit commission, investment returns, agency fees and other income inclusive of foreign exchange gains. The accounting policies for insurance premiums and investment returns are outlined below. Profit commission and other sources of income are recognised on an accruals basis.

### 2.13 Insurance contracts

*(a) Classification*
The Group issues short-term casualty and property insurance contracts that transfer insurance risk. Such contracts may also transfer a limited level of financial risk.

*(b) Recognition and measurement*
Gross premiums written comprise premiums on business incepting in the financial year together with adjustments to estimates of premiums written in prior accounting periods. Estimates are included for pipeline premiums and an allowance is also made for cancellations. Premiums are stated before the deduction of brokerage and commission but net of taxes and duties levied. Premiums are recognised as revenue (earned premiums) proportionally over the period of coverage. The portion of premium received on in-force contracts that relates to unexpired risks at the balance sheet date is reported as the unearned premium liability. Premiums are shown before deduction of commission.

Claims and associated expenses are charged to profit or loss as incurred based on the estimated liability for compensation owed to contract holders or third parties damaged by the contract holders. They include direct and indirect claims settlement costs and arise from events that have occurred up to the balance sheet date even if they have not yet been reported to the Group. The Group does not discount its liabilities for unpaid claims. Liabilities for unpaid claims are estimated using the input of assessments for individual cases reported to the Group and statistical analysis for the claims incurred but not reported, and an estimate of the expected ultimate cost of more complex claims that may be affected by external factors e.g. court decisions.

*(c) Deferred acquisition costs ("DAC")*
Commissions and other direct and indirect costs that vary with and are related to securing new contracts and renewing existing contracts are capitalised as an intangible asset. All other costs are recognised as expenses when incurred. The DAC is amortised over the terms of the policies as premium is earned.

*(d) Liability adequacy test*
At each balance sheet date, liability adequacy tests are performed by each segment of the Group to ensure the adequacy of the contract liabilities net of related DAC. In performing these tests, current best estimates of future contractual cash flows and claims handling and administration expenses, as well as investment income from assets backing such liabilities, are used. Any deficiency is immediately charged to profit or loss initially by writing off DAC and by subsequently establishing a provision for losses arising from liability adequacy tests ("the unexpired risk provision").

Any DAC written off as a result of this test cannot subsequently be reinstated.

*(e) Outwards reinsurance contracts held*
Contracts entered into by the Group, with reinsurers, under which the Group is compensated for losses on one or more insurance or reinsurance contracts and that meet the classification requirements for insurance contracts, are classified as insurance contracts held. Contracts that do not meet these classification requirements are classified as financial assets.

The benefits to which the Group is entitled under outwards reinsurance contracts are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers (classified within loans and receivables) as well as longer-term receivables (classified as reinsurance assets) that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts. Reinsurance liabilities primarily comprise premiums payable for "outwards" reinsurance contracts. These amounts are recognised in profit or loss proportionally over the period of the contract. Receivables and payables are recognised when due.

The Group assesses its reinsurance assets on a regular basis and if there is objective evidence that the reinsurance asset is impaired the Group reduces the carrying amount of the reinsurance asset to its recoverable amount and recognises the impairment loss in the income statement.

*(f) Receivables and payables related to insurance contracts*
Receivables and payables are recognised when due. These include amounts due to and from agents, brokers and insurance contract holders.

If there is objective evidence that the insurance receivable is impaired, the Group reduces the carrying amount of the insurance receivable accordingly and recognises the impairment loss in profit or loss.

*(g) Salvage and subrogation reimbursements*
Some insurance contracts permit the Group to sell property acquired in settling a claim (i.e. salvage). The Group may also have the right to pursue third parties for payment of some or all costs (i.e. subrogation).

Estimates of salvage recoveries are included as an allowance in the measurement of the insurance liability for claims and salvage property is recognised in other assets when the liability is settled. The allowance is the amount that can reasonably be recovered from the disposal of the property.

Subrogation reimbursements are also considered as an allowance in the measurement of the insurance liability for claims and are recognised in other assets when the liability is settled. The allowance is the assessment of the amount that can be recovered from the action against the liable third party.

### 2.14 Deferred tax

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. However, if the deferred income tax arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss, it is not recognised. Deferred tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised to the extent that it is probable that the future taxable profit will be available against which the temporary differences can be utilised.

Deferred tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the Group controls the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

### 2.15 Employee benefits

*(a) Pension obligations*
The Group and the Company operates both defined contribution and defined benefit pension schemes.

A defined contribution plan is a pension plan under which the Group or Company pays fixed contributions into a separate entity and has no further obligation beyond the agreed contribution rate. A defined benefit plan is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and compensation.

For defined contribution plans, the Group and the Company pay contributions to publicly or privately administered pension insurance plans on a contractual basis. The Group and the Company have no further payment obligations once the contributions have been paid.

The contributions are recognised as an employee benefit expense when they are due. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in future payments is available.

The liability recognised in the balance sheet in respect of defined benefit pension plans is the present value of the defined benefit obligation at the balance sheet date less the fair value of plan assets, together with adjustments for unrecognised actuarial gains or losses and past service costs. Plan assets exclude any insurance contracts issued by the Group.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to income over the employees' expected average remaining working lives. Actuarial gains and losses are only recognised when the net cumulative unrecognised actuarial gains and losses for each individual plan at the end of the previous accounting period exceeds 10% of the higher of the defined benefit obligation and the fair value of the plan assets at that date.

Past service costs are recognised immediately in income, unless the changes to the pension plan are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

Rights to reimbursement from other parties participating in the Lloyd's Syndicate of some of the expenditure required to settle the defined benefit obligation are recognised within receivables in accordance with the policies outlined at 2.7 (b) above.

*(b) Other long-term employee benefits*
The Group provides sabbatical leave to employees on completion of a minimum service period of ten years. The present value of the expected costs of these benefits is accrued over the period of employment.

*(c) Share based compensation*
The Group and the Company operate a number of equity settled share based employee compensation plans. These include both the approved and unapproved share option schemes outlined at note 31 together with the Group's save as you earn ('SAYE') schemes.

The fair value of the employee services received in exchange for the grant of the options is recognised as an expense with the corresponding credit being recorded in equity. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted, excluding the impact of any non market vesting conditions (e.g. profitability or net asset growth targets). Non market vesting conditions are included in assumptions about the number of options that are expected to become exercisable. At each balance sheet date, the Group revises its estimates of the number of options that are expected to vest. It recognises the impact of the revision of original estimates, if any, in the income statement, and a corresponding adjustment to equity over the remaining vesting period.

The proceeds received net of any directly attributable transaction costs are credited to share capital and share premium when the options are exercised.

In accordance with the transitional arrangement of IFRS 2, only share options granted after 7 November 2002 but not yet vested at the date of adoption of IFRS, are included in the calculations.

*(d) Termination benefits*
Termination benefits are payable when employment is terminated before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Group recognises termination benefits when it is demonstrably committed to either: terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal; or providing termination benefits as a result of an offer made to encourage voluntary redundancy.

*(e) Profit sharing and bonus plans*
The Group recognises a liability and an expense for bonuses and profit sharing, based on a formula that takes into consideration the profit attributable to the Company's shareholders after certain adjustments. The Group and the Company recognise a provision where contractually obliged or where there is a past practice that has created a constructive obligation.

*(f) Accumulating compensation benefits*
The Group recognises a liability and an expense for accumulating compensation benefits (e.g. holiday entitlement), based on the additional amount that the Group expects to pay as a result of the unused entitlement accumulated at the balance sheet date.

### 2.16 Borrowings
Borrowings are classified as financial liabilities and are designated on inception as being held at fair value through profit or loss. Financial liabilities are consequently measured at fair value at inception and at each balance sheet date thereafter, with all changes in value from one accounting period to the next reflected in the income statement.

### 2.17 Provisions
The Group and the Company are subject to various insurance related assessments or guarantee fund levies. Related provisions are provided for where there is a present obligation (legal or constructive) as a result of a past event.

### 2.18 Leases
Leases in which significantly all of the risks and rewards of ownership are transferred by the Group and the Company are classified as finance leases. At the commencement of the lease term, finance leases are recognised as assets and liabilities at the lower of the fair value of the asset and the present value of the minimum lease payments. The minimum lease payments are apportioned between finance charges and repayments of the outstanding liability, finance charges being charged to each period of the lease term so as to produce a constant rate of interest on the outstanding balance of the liability.

All other leases are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

### 2.19 Dividend distribution
Dividend distribution to the Company's shareholders is recognised as a liability in the Group and Company's financial statements in the period in which the dividends are approved.

### 2.20 Use of critical estimates and assumptions
The inherent uncertainty of insurance risk requires the Group to make estimates and assumptions that affect the reported amounts of assets and liabilities at the balance sheet date. The most significant area of uncertainty in the financial statements relates to the insurance claim liabilities of the Group and the related loss adjustment expenses. Estimates and judgements are continually evaluated based on historical experience and other factors, including expectations of future events that are believed to be reasonable in the circumstances.

There are several sources of uncertainty that need to be considered in the estimation of the liabilities that the Group will ultimately pay for valid claims. These include but are not restricted to: inflation; changes in legislation; changes in the Group's claims handling procedures; and discordant judicial opinions which extend the Group's coverage of risk beyond that envisaged at the time of original policy issuance. The Group seeks to gather corroborative evidence from all relevant sources before making judgements as to the eventual outcome of claims, particularly those under litigation, which have occurred and been notified to the Group but remain unsettled at the balance sheet date.

The Directors consider the accounting policies for determining insurance liabilities, amounts denominated in foreign currencies, the valuation of investments and recognition of premiums, as being most critical to an understanding of the Group and Company's result and position.

Note 25 to consolidated financial statements provides a greater analysis of the main methods used by the Group when formulating estimates of the insurance claims liabilities at each balance sheet date.

## 3 Explanation of transition to IFRSs as adopted by the EU

As stated in note 2.1, these are the Group and Company's first financial statements prepared in accordance with IFRSs as adopted by the EU. The accounting policies set out in note 2 have been applied in preparing the financial statements for the year ended 31 December 2005, the comparative information presented in these financial statements for the year ended 31 December 2004 and in the preparation of an opening IFRSs balance sheet at 1 January 2004 (the date of transition).

In preparing opening IFRSs balance sheets, the Group and Company have adjusted amounts reported previously in financial statements prepared in accordance with its previous basis of accounting (UK GAAP). An explanation of how the transition from UK GAAP to IFRSs has affected the Group and Company's position, financial performance and cash flows is set out in the following tables and the notes that accompany the tables.

The principal changes which have a material impact on either net assets or profit for the year are explained further at notes 3.a to 3.g below:

Consolidated Group balance sheet

| | | 1 January 2004 | | | 31 December 2004 | | |
|---|---|---|---|---|---|---|---|
| | Notes | UK GAAP £000 | Effect of transition to IFRSs £000 | IFRSs £000 | UK GAAP £000 | Effect of transition to IFRSs £000 | IFRSs £000 |
| **Assets** | | | | | | | |
| Property, plant and equipment | | 7,742 | 8 | 7,750 | 10,663 | 28 | 10,691 |
| Intangible assets including intangible insurance assets | 3a, 3g | 123,570 | 2,387 | 125,957 | 138,390 | 1,569 | 139,959 |
| Investments in associates | | 519 | – | 519 | 1,109 | – | 1,109 |
| Financial assets including loans and receivables | 3b | 1,159,275 | (92,125) | 1,067,150 | 1,399,200 | (90,987) | 1,308,213 |
| Current tax | | 2,739 | – | 2,739 | – | – | – |
| Reinsurance contracts receivables | 3g | 252,187 | 1,504 | 253,691 | 238,256 | 615 | 238,871 |
| Cash and cash equivalents | 3b | 52,945 | 49,767 | 102,712 | 61,332 | 58,231 | 119,563 |
| Total assets | | 1,598,977 | (38,459) | 1,560,518 | 1,848,950 | (30,544) | 1,818,406 |
| **Equity** | | | | | | | |
| Share capital | | 14,565 | – | 14,565 | 14,685 | – | 14,685 |
| Share premium | | 232,341 | – | 232,341 | 234,267 | – | 234,267 |
| Currency translation reserve | | – | – | – | – | (468) | (468) |
| Other reserves | | 37,967 | – | 37,967 | 37,967 | – | 37,967 |
| Reserve for own shares | | (686) | 686 | – | (473) | 473 | – |
| Retained earnings | | 45,650 | (15,838) | 29,812 | 85,153 | (2,778) | 82,375 |
| Total equity | 3h | 329,837 | (15,152) | 314,685 | 371,599 | (2,773) | 368,826 |
| **Liabilities** | | | | | | | |
| Employee retirement benefit obligations | 3f | – | 33,334 | 33,334 | – | 34,718 | 34,718 |
| Deferred tax | 3c | 15,503 | (13,858) | 1,645 | 25,261 | (10,744) | 14,517 |
| Insurance contracts | 3d, 3g | 1,097,637 | (36,975) | 1,060,662 | 1,290,936 | (44,033) | 1,246,903 |
| Financial liabilities | | 477 | – | 477 | 57 | – | 57 |
| Current tax | | – | – | – | 7,855 | – | 7,855 |
| Trade and other payables | 3e, 3f | 155,523 | (5,808) | 149,715 | 153,242 | (7,712) | 145,530 |
| Total liabilities | | 1,269,140 | (23,307) | 1,245,833 | 1,477,351 | (27,771) | 1,449,580 |
| Total equity and liabilities | | 1,598,977 | (38,459) | 1,560,518 | 1,848,950 | (30,544) | 1,818,406 |

## 3 Explanation of transition to IFRSs as adopted by the EU continued

### Consolidated Group income statement
For the year ended 31 December 2004

| | Notes | UK GAAP £000 | Effect of transition to IFRSs £000 | IFRSs £000 |
|---|---|---|---|---|
| Income | | | | |
| Gross premiums written | 3g | 778,893 | 37,716 | 816,609 |
| Outward reinsurance premiums | 3g | (97,327) | (15,197) | (112,524) |
| Net premiums written | 3g | 681,566 | 22,519 | 704,085 |
| Net change in provision for unearned premiums | 3g | (39,137) | 49,904 | 10,767 |
| Net premiums earned | | 642,429 | 72,423 | 714,852 |
| Investment result | 3b | 31,999 | 3,807 | 35,806 |
| Other income | 3g | 14,527 | 585 | 15,112 |
| Net revenue | | 688,955 | 76,815 | 765,770 |
| Expenses | | | | |
| Claims and claim adjustment expenses, net of reinsurance | 3g | (355,852) | (26,211) | (382,063) |
| Expenses for the acquisition of insurance contracts | 3g | (165,106) | (12,854) | (177,960) |
| Administration expenses | 3g | (46,557) | 3,359 | (43,198) |
| Other operating expenses | 3a, 3d, 3f, 3g | (42,819) | (28,621) | (71,440) |
| Total expenses | | (610,334) | (64,327) | (674,661) |
| Results of operating activities | | 78,621 | 12,488 | 91,109 |
| Finance costs | 3b | (1,977) | – | (1,977) |
| Share of profit of associates | | 390 | – | 390 |
| Profit before tax | | 77,034 | 12,488 | 89,522 |
| Tax expense | 3c | (22,460) | (3,114) | (25,574) |
| Profit for the year (all attributable to equity shareholders of the Company) | | 54,574 | 9,374 | 63,948 |
| Earnings per share on profit attributable to equity shareholders | | | | |
| Basic (as originally published) | | 18.7p | 3.2p | 21.9p |
| Diluted (as originally published) | | 18.5p | 3.2p | 21.7p |
| Basic (as restated for the effect of the Rights Issue) | | – | – | 21.3p |
| Diluted (as restated for the effect of the Rights Issue) | | – | – | 21.0p |

# Notes to the financial statements continued

## 3 Explanation of transition to IFRSs as adopted by the EU continued

Parent Company balance sheet

| | Notes | 1 January 2004 UK GAAP £000 | Effect of transition to IFRSs £000 | IFRSs £000 | 31 December 2004 UK GAAP £000 | Effect of transition to IFRSs £000 | IFRSs £000 |
|---|---|---|---|---|---|---|---|
| Assets | | | | | | | |
| Property, plant and equipment | | 584 | 8 | 592 | 3,543 | 28 | 3,571 |
| Investments in subsidiary undertakings | | 115,457 | – | 115,457 | 115,457 | – | 115,457 |
| Investments in associate | | – | – | – | 200 | – | 200 |
| Financial assets including loans and receivables | 3b, 3e | 247,133 | 9,042 | 256,175 | 279,151 | 35,065 | 314,216 |
| Cash and cash equivalents | 3e | 129 | 17,564 | 17,693 | 2,222 | 2,961 | 5,183 |
| Total assets | | 363,303 | 26,614 | 389,917 | 400,573 | 38,054 | 438,627 |
| Equity | | | | | | | |
| Share capital | | 14,565 | – | 14,565 | 14,685 | – | 14,685 |
| Share premium | | 232,341 | – | 232,341 | 234,267 | – | 234,267 |
| Other reserves | 3b | 92,377 | (163) | 92,214 | 93,712 | (1,498) | 92,214 |
| Retained earnings | | 5,577 | 1,864 | 7,441 | 4,864 | 13,767 | 18,631 |
| Total equity | | 344,860 | 1,701 | 346,561 | 347,528 | 12,269 | 359,797 |
| Liabilities | | | | | | | |
| Employee retirement benefit obligations | 3f | – | 33,334 | 33,334 | – | 34,718 | 34,718 |
| Deferred tax | | – | – | – | 670 | 1,348 | 2,018 |
| Current tax | | – | – | – | 614 | – | 614 |
| Trade and other payables | 3e | 18,443 | (8,421) | 10,022 | 51,761 | (10,281) | 41,480 |
| Total liabilities | | 18,443 | 24,913 | 43,356 | 53,045 | 25,785 | 78,830 |
| Total equity and liabilities | | 363,303 | 26,614 | 389,917 | 400,573 | 38,054 | 438,627 |

### 3.a Intangible assets

*Goodwill*

Goodwill acquired in a business combination is no longer amortised but is tested for impairment on at least an annual basis. Up to 31 December 1997, under UK GAAP goodwill arising on the acquisition of subsidiaries was written-off directly to reserves in the year of acquisition. From 1 January 1998, in accordance with FRS 10 *Goodwill and Intangible Assets*, goodwill was capitalised and amortised on a straight-line basis over its useful economic life which was deemed to be 20 years. Any goodwill previously amortised or written-off has not been reinstated on adoption of IFRSs and thus the value of goodwill has been taken as the carrying amount on adoption.

*Syndicate capacity*

In accordance with IAS 38 *Intangible Assets*, the useful lives of all of the Group's recognised intangible assets have been reviewed on adoption of IFRSs. Following this review it has been concluded that syndicate capacity has an indefinite useful life and so will no longer be amortised but will be subject to at least annual impairment test. Syndicate capacity previously amortised has been reinstated on adoption of IFRSs.

### 3.b Financial assets

*Valuation*

In the Group and Company's UK GAAP financial statements, financial assets are stated at their current value. For listed investments, comprising those quoted on the London and other international stock exchanges, current value was deemed to be the mid-market prices on the balance sheet date, or on the last stock exchange trading day before the balance sheet date. All realised or unrealised gains and losses were taken to the income statement.

For the purposes of measuring financial assets under IAS 39 *Financial Instruments: Recognition and Measurement* all financial assets are classified into the following four categories:

(a) financial assets at fair value through income

(b) held-to-maturity investments

(c) loans and receivables

(d) available-for-sale financial assets.

A full review of the Group and Company's investments has been performed as part of the adoption of IFRSs and all equities and debt securities have been classified as financial assets at fair value through the income statement.

The accounting for this category of financial asset is similar to the Group's previous accounting policy under UK GAAP. However, under IFRSs listed investments are valued at bid price on the balance sheet date, or on the last stock exchange trading day before the balance sheet date. The accounting for this category of financial asset is different to the parent Company's previous accounting policy under UK GAAP. In addition to being valued on a mid rather than bid price basis, the parent Company's previous accounting policy was also to recognise unrealised fair value adjustments through a capital reserve on the balance sheet rather than through the income statement. This previous accounting treatment was in accordance with Section 226 of, and Schedule 4 to, the Companies Act 1985.

*Derivative financial instruments*

The Group and the Company have entered into a small number of foreign exchange contracts in order to manage its net investment in a foreign operation, and its exposure to business denominated in a currency other than its presentational currency. In accordance with IAS 39 these contracts have been recognised in the balance sheet at their fair value. Fair value gains or losses on these instruments are recognised in the income statement.

*Cash and cash equivalents*
In the Group and Company's UK GAAP financial statements deposits with credit institutions were included within investments. These deposits were predominantly composed of short dated certificates of deposit. Under IFRSs cash equivalents are included with cash at bank and in hand as cash and cash equivalents. IAS 7 *Cash Flow Statements* defines cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. An investment normally qualifies as a cash equivalent only when it has a short maturity of three months or less from the date of acquisition. All certificates of deposit which meet this criteria have been disclosed as cash equivalents in the IFRSs balance sheet. This adjustment has no impact on shareholders' funds or profit after tax.

3.c Taxation
Current tax was provided in the UK GAAP financial statements for amounts expected to be paid (or recovered) using the tax rates and laws that had been enacted or substantially enacted at the balance sheet date.

Deferred tax was recognised in respect of all timing differences, with certain exceptions, that had originated but not reversed at the balance sheet date where transactions or events that result in an obligation to pay more tax or a right to pay less tax in the future had occurred at the balance sheet date. Timing differences are differences between the Group and Company's taxable profits and its results as stated in the UK GAAP financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in the financial statements. Deferred tax was measured at the average tax rates that are expected to apply in periods in which the timing differences are expected to reverse. The Group did not discount its UK GAAP deferred tax assets or liabilities.

IAS 12 *Income Taxes* takes a balance sheet approach with deferred tax being calculated, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply in periods in which the timing differences are expected to reverse.

3.d Insurance contracts
*Equalisation provision*
In the UK GAAP financial statements an equalisation provision was established for Hiscox Insurance Company Limited in accordance with the requirements of PRU 7.5 of the Integrated Prudential Sourcebook (Insurance and other amendments) Instrument 2004. This provision, which was in addition to the provisions required to meet the anticipated ultimate cost of settlement of outstanding claims at the balance sheet date, was required by Schedule 9A to the Companies Act 1985 to be included within technical provisions at the balance sheet date notwithstanding that it does not represent liabilities at the balance sheet date.

Under IFRS 4, provisions for possible future claims arising from insurance contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions) are not recognised.

3.e Dividend recognition
Under UK GAAP dividends are recognised in the income statement in the period to which they relate irrespective of when they are declared and approved. IAS 10 *Events after the Balance Sheet Date* does not allow the recognition of dividends to holders of equity instruments approved after the balance sheet date because they do not meet the criteria of a present obligation in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Accordingly only dividends approved (i.e. appropriately authorised and no longer at the discretion of the Group or Company) are recognised as receivable or payable at the balance sheet date. In addition, under IFRSs dividend distributions by the Company are debited directly to reserves instead of being reflected in the Income Statement for the year.

3.f Employee benefits
*Retirement benefit obligations*
Under IAS 19 *Employee Benefits* the present value of the defined benefit obligation is matched against the fair value of the plan assets out of which the obligations are to be settled directly and other unrecognised actuarial gains and losses. The resulting pension scheme asset or liability is recognised in the balance sheet. Previously under UK GAAP the assets and liabilities of defined benefit pension schemes were off-balance sheet items which were only disclosed by way of a footnote. Under SSAP 24 *Accounting for Pension Costs*, pension contributions were charged to the income statement so as to spread the cost of pensions over employees' working lives with the Group. Differences between these amounts charged and payments made to the Group's pension schemes were treated as an asset or liability in the UK GAAP balance sheet.

The standard also allows the recognition of a right to reimbursement from other parties of some of the expenditure required to settle the defined benefit obligation. Accordingly, the Group has recognised income and a corresponding asset representing the share of the defined benefit obligation paid or payable by third party capital providers on Syndicate 33.

*Share-based payments*
IFRS 2 *Share-based Payment* requires the recognition of an expense representing the fair value of employee services rendered in exchange for the grant of options. The amount to be expensed has been determined by reference to the fair value of the options granted. The impact of any non-market vesting conditions is not included in the calculation of the fair value but is included in the assumptions about the number of options that are expected to become exercisable. The fair value is expensed over the vesting period which is three years for all of the Group's share option schemes.

In accordance with the transitional arrangements contained in the standard, only share options granted after 7 November 2002 but not yet vested at 1 January 2005 were included in the calculations.

*Sabbatical leave*
After ten years of service, all permanent employees of the Group are eligible to take an eight week paid sabbatical leave. The present value of the cost of this compensated absence is expensed in the income statement over the period of service in accordance with IAS 19.

3.g Rates of exchange
*Functional currency*
The functional currency is the currency of the primary economic environment in which an entity operates. The functional currency of all entities in the Group has been deemed to be Sterling with the exception of the entities operating in France, Germany, the Netherlands and Belgium whose functional currency are Euros, and Hiscox Insurance Company (Guernsey) Limited, Hiscox Inc. and Hiscox Insurance Company (Bermuda) Limited, whose functional currency are US Dollars.

IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires that foreign currency transactions are recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. Exchange differences

arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition in the functional currency during the period or in previous financial statements are recognised in the income statement when they arise.

Under IFRSs unearned premium and deferred acquisition costs are non monetary assets and liabilities and accordingly are not retranslated from the historic rates. Previously, the retranslation of these items at the closing rate was permitted under UK GAAP.

*Presentational currency*
The presentational currency of the Group and the Company, which is the currency used in the presentation of the consolidated Group and Company financial statements, is Sterling. The results and financial position of those entities whose functional currency is not Sterling have been translated to the presentational currency as follows:

- all assets and liabilities are translated at the closing rate at the balance sheet date
- income and expenses are translated at the exchange rates prevailing on the dates of transactions
- all resulting exchange differences are recognised as a separate component of equity.

Previously under UK GAAP, investments in foreign enterprises were translated by the Group using the net investment method which applies the closing rate to all assets and liabilities and income and expenses. All resulting exchange differences were similarly taken to reserves.

*Daily transactional rates*
As part of the system improvements made on adoption of IFRSs the Group has moved to daily transactional rates of exchange as it believes that this provides more accurate financial information. The only exception to this is for business whose functional currency is not denominated in Sterling for which average monthly rates continue to be adopted for the translation into the presentational currency.

*Disclosure*
All exchange differences arising on the retranslation of monetary assets and liabilities to functional currency at the balance sheet date have been taken to the income statement and included in other operating income or expenses. Under UK GAAP these differences were included on a line by line basis throughout the income statement.

### 3.h Summary reconciliation of opening equity at date of transition

| | Notes | Group £000 | Company £000 |
|---|---|---|---|
| Total equity at 1 January 2004 reported previously under UK GAAP | | 329,837 | 344,860 |
| Employee benefits | 3f | (40,987) | 854 |
| Deferred tax | 3c | 13,858 | – |
| Rates of exchange | 3g | (17,679) | – |
| Intangible assets | 3a | 4,830 | – |
| Dividend recognition | 3e | 8,414 | 921 |
| Insurance contracts | 3d | 16,476 | – |
| Other adjustments | | (64) | (74) |
| Total equity at 1 January 2004 in accordance with IFRSs | | 314,685 | 346,561 |

### 3.i Explanation of material adjustments to the cash flow statement
The transition from UK GAAP to IFRSs necessitates significant presentational and other adjustments being made to the Group's previously reported cash flow statement for the year ended 31 December 2004. IAS 7 *Cash Flow Statements* prescribes a format for presenting the Group's cash flows that is more condensed than the comparable UK GAAP standard FRS 1 *Cash Flow Statements*. Previously the Group's cash flows were classified under eight standard headings.

IAS 7 now requires that the Group's cash flow statement be condensed into three standard headings: operating, investing and financing activities. The difference in format means that the Group's UK GAAP and IFRSs cash flow statements are not comparable on a line by line basis. Cash flows from capital expenditure, acquisitions and disposals, shown separately under UK GAAP, are now included as part of investing activities under IFRSs. The payment of dividends is included as a financing activity under IFRSs.

Interest received, together with the receipt of dividends on equity investments (including those payable by subsidiary undertakings) are presented within cash flows from operational activities.

Under UK GAAP the Group and Company's cash comprises cash at bank. Under IFRSs, cash and cash equivalents include both cash at bank and other short-term highly liquid investments, such as certificates of deposit, with original maturities of three months or less.

Previously the Group's cash flow statement excluded cash flows relating to underwriting on Lloyd's syndicates. On transition to IFRSs these have now been included.

## 4 Management of insurance and financial risk
The Group enters into contracts that directly accept and transfer insurance risk, which in turn creates exposures to financial and other classes of risk. Consequently, Hiscox is fundamentally concerned with the identification and management of all significant risks. The Board has set Group-wide risk management policies which cover specific areas such as risk tolerance boundaries and procedures for communicating risk matters in a timely manner to management.

The main sources of risk relevant to the financial statements are set out below together with an outline of the ways in which the Group and Company manages them. Additional information is also provided in the Corporate governance and Risk management sections of this Annual Report.

### 4.1 Insurance risk and exposure controls
Insurance risk is transferred to the Group by contract holders through the underwriting process.

The Group's overall appetite for accepting varying classes of insurance risk is set by the Group's Board. Management of insurance risk on a day-to-day basis is the responsibility of the Chief Underwriting Officer, who receives assistance from the management information and risk modelling departments.

The Group's exposure to insurance risk arises from the possibility that an insured event occurs, and a claim is subsequently submitted by the insured for payment. The Group considers insurance risk at an individual contract level, and also from a portfolio perspective where the risks assumed in similar classes of policies are aggregated and the exposure evaluated in light of historical portfolio experience and prospective factors.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal accounting risk that the Group faces is that the actual claim payments required exceed the projected amount of the insurance liabilities. This could occur because the frequency or severity of claims is greater than estimated. Insurance events are unpredictable in terms of occurrence, timing and magnitude. This means that the actual number and amount of claims will vary from the estimates established using statistical techniques. Other unpredictable factors that contribute towards the Group's insurance risk accounting exposure include the emergence of latent risks and legal developments such as broadening judicial interpretations of coverage and the measurement of damages, none of which can be quantified with any absolute certainty at the balance sheet date.

Historical experience suggests that the larger the portfolio of similar insurance contracts, the smaller the relative variability about the expected outcome will be. Factors that may increase insurance risk include lack of diversification in terms of type and amount of risk, geographical location and type of policyholder covered. Consequently, the Group seeks to diversify risk acceptances where possible. However, significant geographical concentrations of risk can exist within individual segments of the portfolio. The Group's reserves are calculated by an experienced in-house team of actuaries. The amounts reserved are subject to frequent peer reviews and, for the managed Syndicate, an annual actuarial audit is also performed by external actuaries.

To assist with the process of pricing and managing insurance risk the Group routinely performs a wide range of activities including the following:

- regularly updating the Group's risk models
- documenting, monitoring and reporting on the Group's strategy to manage risk
- developing systems that facilitate the identification of emerging issues promptly
- utilising sophisticated computer modelling tools to simulate catastrophes and measure the resultant potential losses before and after reinsurance
- monitoring legal developments and amending the wording of policies when necessary
- regularly aggregating risk exposures across individual underwriting portfolios and known accumulations of risk
- examining the aggregated exposures in advance of underwriting further large risks
- developing processes that continually factor market intelligence into the pricing process.

All underwriting staff and binding agencies are set strict parameters in relation to the levels and types of business they can underwrite, based on individual levels of experience and competence. The delegation of underwriting authority to specific individuals, both internally and externally, is subject to regular review.

Regular meetings are held between the leaders of individual underwriting teams and the Chief Underwriting Officer, the risk modelling department and the actuarial department in order to monitor claim development patterns and discuss individual issues as they arise.

One tool for managing insurance risk is reinsurance. Considerable reinsurance protection such as excess of loss cover is purchased at an entity level and is also considered at an overall Group level to mitigate the effect of catastrophes. The scope and type of reinsurance protection purchased may change depending on the competitiveness of cover available in the market. Very large or complex risks are often shared with a number of other insurers under co-insurance arrangements.

The Group's insurance contracts include provisions to contain losses such as the ability to impose deductibles and demand reinstatement premiums in certain cases. In addition, in order to manage the Group's exposure to repeated catastrophic events, relevant policies frequently contain payment limits to cap the maximum amount payable from these insured events over the contract period.

The Group's internal audit function, which is wholly independent of the underwriting function, performs reviews throughout the Group to verify that underwriting teams are in compliance with the Board's policies and required procedures.

The Board requires all underwriters to operate within an overall Group appetite for individual events. This defines the maximum exposure that the Group is prepared to retain on its own account for any one potential catastrophe event or disaster.

The Group's maximum net claims exposure during 2006 for a single potential natural event with an expected occurrence of once in 250 years is estimated at £140 million.

The Group also seeks to limit the net amount of risk retained on the account for other large risks and non natural perils such as major accidents or acts of terrorism to no more than £105 million per event.

The Group's concentration of insurance risk, in relation to the broad categories of insurance liabilities reserved on the balance sheet, is summarised overleaf.

4.1 Insurance risk and exposure controls continued

Gross and net insurance liabilities on balance sheet

31 December 2005

| | | Reinsurance inwards £000 | Property – Marine and major assets £000 | Property – Other assets £000 | Casualty – Professional indemnity £000 | Casualty – Other risks £000 | Other* £000 | Total £000 |
|---|---|---|---|---|---|---|---|---|
| | | | Type of risk | | | | | |
| Territory of policyholder | | | | | | | | |
| UK and Ireland | Gross | 61,792 | 33,921 | 96,063 | 227,692 | 45,959 | 54,357 | 519,784 |
| | Net | 33,432 | 22,375 | 87,538 | 185,025 | 30,947 | 30,938 | 390,255 |
| Europe | Gross | 33,467 | 20,078 | 59,242 | 36,644 | 6,378 | 14,351 | 170,160 |
| | Net | 17,036 | 12,608 | 52,322 | 29,865 | 4,885 | 9,802 | 126,518 |
| United States | Gross | 244,726 | 190,390 | 118,921 | 185,433 | 51,595 | 41,070 | 832,135 |
| | Net | 136,142 | 115,728 | 87,047 | 163,828 | 39,284 | 29,842 | 571,871 |
| Rest of World | Gross | 39,433 | 65,860 | 19,040 | 20,301 | 10,999 | 45,288 | 200,921 |
| | Net | 23,066 | 34,611 | 14,975 | 17,972 | 8,149 | 29,207 | 127,980 |
| Total | Gross | 379,418 | 310,249 | 293,266 | 470,070 | 114,931 | 155,066 | 1,723,000 |
| | Net | 209,676 | 185,322 | 241,882 | 396,690 | 83,265 | 99,789 | 1,216,624 |

Gross and net insurance liabilities on balance sheet

31 December 2004

| | | Reinsurance inwards £000 | Property – Marine and major assets £000 | Property – Other assets £000 | Casualty – Professional indemnity £000 | Casualty – Other risks £000 | Other* £000 | Total £000 |
|---|---|---|---|---|---|---|---|---|
| | | | Type of risk | | | | | |
| Territory of policyholder | | | | | | | | |
| UK and Ireland | Gross | 9,156 | 31,430 | 79,046 | 209,547 | 35,821 | 54,916 | 419,916 |
| | Net | 6,594 | 25,542 | 75,548 | 161,825 | 20,764 | 35,506 | 325,779 |
| Europe | Gross | 6,235 | 10,821 | 48,023 | 27,197 | 4,550 | 12,618 | 109,444 |
| | Net | 5,531 | 8,444 | 44,895 | 20,134 | 2,895 | 9,515 | 91,414 |
| United States | Gross | 120,553 | 118,917 | 96,996 | 152,609 | 36,991 | 44,820 | 570,886 |
| | Net | 103,021 | 103,867 | 89,425 | 125,947 | 28,238 | 34,469 | 484,967 |
| Rest of World | Gross | 8,759 | 55,299 | 14,457 | 18,356 | 8,070 | 41,716 | 146,657 |
| | Net | 7,881 | 38,433 | 12,804 | 15,140 | 5,287 | 26,327 | 105,872 |
| Total | Gross | 144,703 | 216,467 | 238,522 | 407,709 | 85,432 | 154,070 | 1,246,903 |
| | Net | 123,027 | 176,286 | 222,672 | 323,046 | 57,184 | 105,817 | 1,008,032 |

*Includes a diverse mix of certain specialty lines such as kidnap and ransom, terrorism, bloodstock and other risks which contain a mix of property and casualty exposures.

Frequency and severity of claims

The specific insurance risks accepted by the Group fall into four main categories: reinsurance inwards, marine and major property risks, other property risks and casualty insurance risks. A discussion of the frequency and severity of claims for each of those categories is given below. The Group has no significant exposure to asbestos risks or life and health insurance business.

*Reinsurance inwards*

The Group's reinsurance inwards acceptances are primarily focused on large commercial property, homeowner and marine exposures held by other insurance companies predominantly in North America and other developed economies. This business is characterised more by large claims arising from individual events or catastrophes than the high frequency, low severity attritional losses associated with certain other business written by the Group. Multiple insured losses can periodically arise out of a single natural or man-made occurrence.

The main circumstances that result in claims against the reinsurance inwards book are conventional catastrophes, such as earthquakes or storms, and other events including fires and explosions. The occurrence and impact of these events is very difficult to model over the short-term which complicates attempts to anticipate loss frequencies on an annual basis. In those years where there is a low incidence of severe catastrophes, loss frequencies on the reinsurance inwards book can be relatively low.

A significant proportion of the reinsurance inwards business provides cover on an excess of loss basis for individual events. The Group agrees to reimburse the cedant once their losses exceed a minimum level. Consequently the frequency and severity of reinsurance inwards' claims is related not only to the number of significant insured events that occur but also to their individual magnitude. If numerous catastrophes occurred in any one year but the cedant's individual loss on each was below the minimum stated, then the Group would have no liability under such contracts.

Maximum gross line sizes and aggregate exposures are set for each type of programme. At current exchange rates, the normal maximum individual line size that the Group would commit to is £20 million, and this would only apply to certain segments of the reinsurance inwards business such as catastrophe excess of loss cover. Line limits are strictly adhered to in order to cap the Group's maximum exposure. In almost all cases the reinsurance inwards lines actually written are well below maximum levels.

*Property risks – Marine and major assets*
The Group directly underwrites a diverse range of property risks. The risk profile of the property covered under marine and major asset policies is different to that typically contained in the other classes of property (such as private households and contents insurance) covered by the Group.

Typical property covered by marine and other major property contracts include fixed and moveable assets such as ships and other vessels, cargo in transit, energy platforms and installations, pipelines, other subsea assets, satellites, commercial buildings and industrial plants and machinery. These assets are typically exposed to a blend of catastrophic and other large loss events, and attritional claims arising from conventional hazards such as collision, flooding, fire and theft.

Climatic changes may give rise to more frequent and severe extreme weather events (for example earthquakes, windstorms and river flooding etc.) and it may be expected that their frequency will increase over time.

For this reason the Group accepts major property insurance risks for periods of mainly one year so that each contract can be re-priced on renewal to reflect the continually evolving risk profile. The most significant risks covered for periods exceeding one year are certain specialist lines such as marine and offshore construction projects which can typically have building and assembling periods of between three and four years. These form a small proportion of the Group's overall portfolio.

Marine and major property contracts are normally underwritten by reference to the commercial replacement value of the property covered. The cost of repairing or rebuilding assets, of replacement or indemnity for contents and time taken to restart or resume operations to original levels for business interruption losses are the key factors that influence the level of claims under these policies.

*Other property risks*
The Group provides home and contents insurance, together with cover for art work, antiques, classic cars, jewellery, collectables and other assets held by affluent individuals.

Events which can generate claims on these contracts include burglary, acts of vandalism, fires, flooding and storm damage. Losses can be predicted with a good degree of certainty as the locations of the assets covered, and the individual levels of security taken by owners, are relatively static from one year to the next. The losses associated with these contracts tend to be of a higher frequency and lower severity than the marine and other major property assets covered above.

The Group's home and contents insurance contracts are exposed to weather and climatic risks such as floods and windstorms and their consequences. As outlined earlier the frequency and severity of these losses do not lend themselves to accurate prediction over the short-term. Contract periods are therefore not normally more than one year at a time to enable risks to be regularly re-priced.

Contracts are underwritten by reference to the commercial replacement value of the properties and contents insured, and claims payment limits are always included to cap the amount payable on occurrence of the insured event.

*Casualty insurance risks*
The casualty underwriting strategy attempts to ensure that the underwritten risks are well diversified in terms of type and amount of potential hazard, industry and geography. However, the Group's exposure is more focused towards marine, professional and technological liability risks rather than human bodily injury risks, which are only accepted under limited circumstances. Claims typically arise from incidents such as errors and omissions attributed to the insured, professional negligence and specific losses suffered as a result of electronic or technological failure of software products and websites. The Group's casualty insurance contracts mainly experience low severity attritional losses.

The Group's pricing strategy for casualty insurance policies is typically based upon historical claims frequencies and average claim severities, adjusted for inflation and extrapolated forwards to incorporate projected changes in claims patterns. In determining the price of each policy an allowance is also made for acquisition and administration expenses, reinsurance costs, investment returns and the Group's cost of capital.

### Sources of uncertainty in the estimation of future claim payments
The Group's procedures for estimating the outstanding costs of settling insured losses at the balance sheet date, including those not yet notified by, or apparent to, the insured, are detailed in note 25.

The uncertainty in estimating the ultimate cost of claims typically centres on factors such as agreeing the extent of policy coverage, estimating the amount of the policyholder's loss that is directly attributable to the insured event, and uncertainty regarding the timing and expense of handling the ultimate settlement.

The majority of the Group's insurance risks are short tail and claims are normally notified and settled within 12 months of the insured event occurring. Those claims taking the longest time to develop and settle typically relate to casualty risks where legal complexities occasionally develop regarding the insured's alleged omissions or negligence. Certain marine and property insurance contracts such as those relating to subsea and other energy assets, and the related business interruption risks, can also take longer than normal to settle. This is because of the length of time required for detailed subsea surveys to be carried out and damage assessments agreed together with difficulties in predicting when the assets can be brought back into full production.

The majority of the Group's casualty exposures are on a claims made basis. However the final quantum of these claims may not be established for a number of years after the event. Consequently a significant proportion of the casualty insurance amounts reserved on the balance sheet may not be expected to settle within 12 months of the balance sheet date. A greater proportion of the casualty claims provision at the year end relates to IBNR losses than the provisions made for property and other categories of insurance risks.

### 4.2 Financial risk
The Group and the Company are exposed to financial risk through their ownership of financial assets, financial liabilities, reinsurance assets and insurance liabilities. In particular the key financial risk for the Group is that the proceeds from its financial assets are not sufficient to fund the obligations arising from its insurance contracts. The most important components of this financial risk are interest rate risk, credit risk, liquidity risk and currency risk. The Group and the Company's exposure to equity price risk is limited to a small proportion of the investment portfolio and is diversified over a number of companies and industries.

An analysis of the Group and the Company's exposure to each significant component of financial risk is given in Sections 4.3 to 4.6 below.

4.3 Interest rate risk
Financial investments represent a significant proportion of the Group and the Company's assets and the Board continually monitors investment strategy to minimise the risk of a fall in the portfolio's market value which could affect the amount of business that the Group is able to underwrite or its ability to settle claims as they fall due. The vast majority of the Group and the Company's investments comprise debt and fixed income securities. The fair value of the Group and the Company's investment portfolio of debt and fixed income securities is inversely correlated to movements in market interest rates. If market interest rates fall, the fair value of the Group and the Company's debt and fixed income investments would tend to rise and vice versa.

Debt and fixed income assets are predominantly invested in high quality corporate, government and municipal bonds. The investments typically have relatively short durations and terms to maturity.

The fair value of debt and fixed income assets in the Group's balance sheet at 31 December 2005 was £1,029 million (2004: £834 million). Using a duration-convexation based sensitivity analysis, if market interest rates had risen by 100 basis points at the balance sheet date, the fair value might have been expected to decrease by £13 million (2004: decrease of £6 million).

The fair value of the Company's debt and fixed income assets at 31 December 2005 was £95 million (2004: £96 million). A duration-convexation sensitivity analysis suggests that, if market interest rates had risen by 100 basis points at the balance sheet date, their fair value might have been expected to decrease by £1 million (2004: decrease of £1 million).

Insurance contract liabilities are not directly sensitive to the level of market interest rates, as they are undiscounted and contractually non-interest-bearing.

The Group and the Company's major borrowing facility at 31 December 2005 totalled £120,930,000 (2004: nil) and incurred a fixed rate of interest of 5.61%. This interest rate has been reset several times subsequent to the year end, and is currently fixed at 6.06% until 31 July 2006. The Group and the Company have no other significant borrowings or other assets or liabilities carrying interest rate risk, other than the facilities and letters of credit outlined in note 33.

4.4 Credit risk
The Group and the Company have exposure to credit risk, which is the risk that a counterparty will suffer a deterioration in solvency or be unable to pay amounts in full when due.

Key areas of exposure to credit risk include:

– reinsurers' share of insurance liabilities

– amounts due from reinsurers in respect of claims already paid

– amounts due from insurance contract holders

– amounts due from insurance intermediaries

– counterparty risk with respect to investments including deposits and derivative transactions.

The Group and the Company structure the levels of credit risk accepted by placing limits on their exposure to a single counterparty, or Groups of counterparties, and to geographical and industry segments. Such risks are subject to an annual or more frequent review. There is no significant concentration of credit risk with respect to loans and receivables, as the Group has a large number of internationally dispersed debtors. The Company's loans and receivables are largely due from other Group companies.

Reinsurance is used to contain insurance risk. This does not, however, discharge the Group's liability as primary insurer. If a reinsurer fails to pay a claim for any reason, the Group remains liable for the payment to the policyholder. The creditworthiness of reinsurers is continually reviewed throughout the year.

The Group Reinsurance Security Committee assesses the creditworthiness of all reinsurers by reviewing credit grades provided by rating agencies and other publicly available financial information detailing their financial strength and performance. The financial analysis of reinsurers produces an assessment categorised by Standard & Poor's (S&P) rating (or equivalent when not available from S&P). The Committee considers the reputation of its reinsurance partners and also receives details of recent payment history and the status of any ongoing negotiations between Group companies and these third parties. This information is used to update the reinsurance purchasing strategy.

Individual operating units maintain records of the payment history for significant brokers and contract holders with whom they conduct regular business. The exposure to individual counterparties is also managed by other mechanisms, such as the right of offset where counterparties are both debtors and creditors of the Group. Management information reported to the Group's Board includes details of provisions for impairment on loans and receivables and subsequent write-off. Exposures to individual intermediaries and groups of intermediaries are collected within the ongoing monitoring of the controls associated with regulatory solvency.

The Group and the Company also mitigate their credit counterparty risk by concentrating debt and fixed income investments in high quality instruments, including a particular emphasis on government gilts issued mainly by European Union and North American countries.

An analysis of the Group and Company's major exposures to counterparty credit risk excluding loans and receivables, based on Standard & Poor's or equivalent rating, is presented overleaf:

4.4 Credit risk continued

Group

As at 31 December 2005

| | Notes | AAA £000 | AA £000 | A £000 | Other/ not rated £000 | Total £000 |
|---|---|---|---|---|---|---|
| Debt and fixed income securities | 19 | 733,809 | 57,648 | 128,326 | 109,012 | 1,028,795 |
| Assets arising from reinsurance contracts held | | 28,481 | 162,066 | 317,081 | 46,210 | 553,838 |
| Cash and cash equivalents | 22 | 291,548 | 112,039 | 10,169 | 3 | 413,759 |
| Deposits with credit institutions | 19 | – | 7,466 | 82,110 | – | 89,576 |
| Derivative financial assets/(liabilities) | 19, 21 | – | (5,056) | – | – | (5,056) |
| Total | | 1,053,838 | 334,163 | 537,686 | 155,225 | 2,080,912 |

As at 31 December 2004

| | Notes | AAA £000 | AA £000 | A £000 | Other/ not rated £000 | Total £000 |
|---|---|---|---|---|---|---|
| Debt and fixed income securities | 19 | 548,594 | 56,289 | 167,622 | 61,458 | 833,963 |
| Assets arising from reinsurance contracts held | | 11,670 | 81,530 | 132,899 | 47,160 | 273,259 |
| Cash and cash equivalents | 22 | – | 100,212 | 19,347 | 4 | 119,563 |
| Deposits with credit institutions | 19 | – | 4,524 | 54,113 | – | 58,637 |
| Derivative financial assets | 19, 21 | – | 1,348 | – | – | 1,348 |
| Total | | 560,264 | 243,903 | 373,981 | 108,622 | 1,286,770 |

Company

As at 31 December 2005

| | Notes | AAA £000 | AA £000 | A £000 | Other/ not rated £000 | Total £000 |
|---|---|---|---|---|---|---|
| Debt and fixed income securities | 19 | 63,549 | 10,243 | 7,149 | 14,398 | 95,339 |
| Deposits with credit institutions | 19 | – | 634 | – | – | 634 |
| Cash and cash equivalents | 22 | – | 11,945 | – | – | 11,945 |
| Derivative financial assets/(liabilities) | 19, 21 | – | (5,056) | – | – | (5,056) |
| Total | | 63,549 | 17,766 | 7,149 | 14,398 | 102,862 |

As at 31 December 2004

| | Notes | AAA £000 | AA £000 | A £000 | Other/ not rated £000 | Total £000 |
|---|---|---|---|---|---|---|
| Debt and fixed income securities | 19 | 68,557 | 8,269 | 15,267 | 4,156 | 96,249 |
| Cash and cash equivalents | 22 | – | 5,183 | – | – | 5,183 |
| Derivative financial assets | 19, 21 | – | 1,348 | – | – | 1,348 |
| Total | | 68,557 | 14,800 | 15,267 | 4,156 | 102,780 |

# Notes to the financial statements continued

### 4.5 Liquidity risk

The Group is exposed to daily calls on its available cash resources mainly from claims arising from insurance contracts. Liquidity risk is the risk that cash may not be available to pay obligations when due at a reasonable cost. The Board sets limits on the minimum level of maturing funds available to meet such calls and on the minimum level of borrowing facilities that should be in place to cover maturities, claims and surrenders at unexpected levels of demand.

The vast majority of the Group and the Company's investments are in highly liquid assets which could be converted into cash in a prompt fashion and at minimal expense. The deposits with credit institutions largely comprise short dated certificates for which an active market exists and which the Group can easily access. The Group and the Company's exposure to equities is concentrated on shares and funds that are frequently traded on internationally recognised stock exchanges.

The main focus of the investment portfolio is on high quality and frequently traded short duration debt and fixed income securities. Notwithstanding the regular interest receipts and also the Group and the Company's ability to liquidate these securities for cash in a prompt and reasonable manner, the maturity profile of these securities at 31 December 2005 was as follows:

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Less than one year | 167,175 | 309,353 | 37,936 | 36,461 |
| Between one and two years | 295,897 | 135,032 | 22,169 | 28,785 |
| Between three and five years | 327,522 | 255,723 | 31,182 | 29,952 |
| Over five years | 174,660 | 95,098 | 2,004 | – |
| Sub-total | 965,254 | 795,206 | 93,291 | 95,198 |
| Perpetual notes and other non-dated instruments | 63,541 | 38,757 | 2,048 | 1,051 |
| Total debt and fixed income securities | 1,028,795 | 833,963 | 95,339 | 96,249 |

| Average maturity analysed by denominational currency of investments | 2005 Years | 2004 Years | 2005 Years | 2004 Years |
|---|---|---|---|---|
| Pound Sterling | 5.65 | 3.50 | 2.20 | 1.53 |
| US Dollar | 6.01 | 3.26 | – | – |
| Euro | 3.83 | 4.08 | – | – |
| Canadian Dollar | 0.84 | 0.04 | – | – |

### 4.6 Currency risk

The Group operates internationally and its exposures to foreign exchange risk arise primarily with respect to the US Dollar and the Euro. The assets of the Group's Bermudan, US and European insurance businesses are generally invested in assets denominated in the same currencies as their insurance and investment liabilities. However, the non retranslation of non monetary insurance assets and liabilities such as unearned premiums at each balance sheet date results in exchange gains and losses which impact on the income statement. The profile of the Group's assets and liabilities, categorised by currency at their translated carrying amount, at 31 December was as follows:

As at 31 December 2005

| | Sterling £000 | US Dollar £000 | Euro £000 | Other £000 | Total £000 |
|---|---|---|---|---|---|
| Property, plant and equipment | 11,311 | 388 | 429 | – | 12,128 |
| Intangible assets | 33,099 | – | – | – | 33,099 |
| Deferred acquisition costs | 29,071 | 54,226 | 19,632 | 3,818 | 106,747 |
| Investments in associates | 18 | – | – | – | 18 |
| Financial assets | 450,142 | 623,824 | 136,220 | 27,592 | 1,237,778 |
| Assets arising from reinsurance contracts held | 67,762 | 415,793 | 18,104 | 4,717 | 506,376 |
| Loans and receivables including insurance receivables | 187,566 | 199,032 | 40,901 | 9,482 | 436,981 |
| Cash and cash equivalents | 43,039 | 325,282 | 27,410 | 18,028 | 413,759 |
| Total assets | 822,008 | 1,618,545 | 242,696 | 63,637 | 2,746,886 |

| | Sterling £000 | US Dollar £000 | Euro £000 | Other £000 | Total £000 |
|---|---|---|---|---|---|
| Insurance contracts | 394,652 | 1,140,620 | 154,351 | 33,377 | 1,723,000 |
| Financial liabilities | 260 | 125,986 | – | – | 126,246 |
| Trade and other payables | 142,090 | 79,226 | 38,070 | 12,790 | 271,176 |
| Deferred tax | 15,193 | – | – | – | 15,193 |
| Employee retirement benefit obligations | 16,677 | – | – | – | 16,677 |
| Current tax | 16,581 | – | – | – | 16,581 |
| Total liabilities | 584,453 | 1,345,832 | 192,421 | 46,167 | 2,168,873 |

### 4.6 Currency risk continued

As at 31 December 2004

| | Sterling £000 | US Dollar £000 | Euro £000 | Other £000 | Total £000 |
|---|---|---|---|---|---|
| Property, plant and equipment | 10,412 | – | 279 | – | 10,691 |
| Intangible assets | 29,989 | – | – | – | 29,989 |
| Deferred acquisition costs | 33,945 | 59,801 | 13,856 | 2,368 | 109,970 |
| Investments in associates | 200 | 909 | – | – | 1,109 |
| Financial assets | 347,052 | 486,510 | 112,537 | 34,632 | 980,731 |
| Assets arising from reinsurance contracts held | 69,009 | 149,843 | 19,840 | 179 | 238,871 |
| Loans and receivables including insurance receivables | 131,255 | 167,670 | 23,423 | 5,134 | 327,482 |
| Cash and cash equivalents | 62,340 | 23,106 | 27,674 | 6,443 | 119,563 |
| Total assets | 684,202 | 887,839 | 197,609 | 48,756 | 1,818,406 |

| | Sterling £000 | US Dollar £000 | Euro £000 | Other £000 | Total £000 |
|---|---|---|---|---|---|
| Insurance contracts | 352,920 | 735,338 | 134,767 | 23,878 | 1,246,903 |
| Financial liabilities | 57 | – | – | – | 57 |
| Trade and other payables | 60,116 | 73,108 | 11,259 | 1,047 | 145,530 |
| Deferred tax | 14,517 | – | – | – | 14,517 |
| Employee retirement benefit obligations | 34,718 | – | – | – | 34,718 |
| Current tax | 7,855 | – | – | – | 7,855 |
| Total liabilities | 470,183 | 808,446 | 146,026 | 24,925 | 1,449,580 |

The Company's main foreign currency exposures relate to financial assets (note 19) and its net investment in the Bermudan operation. The Company hedges its net investment in the Bermuda operation by borrowing a proportion of the sum invested in US Dollars which is the functional currency of Hiscox Insurance Company (Bermuda) Limited (note 19). The Company's remaining exposure is partially hedged by way of a forward contract derivative instrument (note 21).

## 5 Segmental information

At 31 December 2005, the Group was managed on a worldwide basis in three primary business segments:

- Global Markets and Corporate Centre comprises the results of Syndicate 33, excluding Syndicate 33's specie, fine art and non-US household business. It also includes the investment return and administrative costs associated with the Company and other Group management activities.
- UK and Europe comprises the results of Hiscox Insurance Company Limited, the results of Syndicate 33's specie, fine art and non-US household business, together with income and expenses arising from the Group's retail agency activities in the UK and in continental Europe.
- International comprises the results of Hiscox Insurance Company (Guernsey) Limited and Hiscox Insurance Company (Bermuda) Limited which commenced underwriting on 1 January 2006. This segment also includes the activities of the Group's newly formed US agency, Hiscox Inc.

This segmentation reflects the internal operational structure within the Group and how the business units are strategically managed to offer different products and services, with different risk profiles, to specific customer Groups. All revenue sources are captured by one of the three business segments shown above.

## 5 Segmental information continued

The primary segment results for the year are as follows:

(a) Profit before tax by segment

| | Year to 31 December 2005 | | | | Year to 31 December 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 |
| Gross premiums written | 555,183 | 262,271 | 43,720 | 861,174 | 511,491 | 267,801 | 37,317 | 816,609 |
| Net premiums written | 417,128 | 235,276 | 28,832 | 681,236 | 451,517 | 233,103 | 19,465 | 704,085 |
| Net premiums earned | 428,334 | 241,603 | 23,362 | 693,299 | 483,958 | 212,368 | 18,526 | 714,852 |
| Investment result based on longer term rates of return | 36,181 | 14,300 | 1,632 | 52,113 | 28,011 | 11,374 | 414 | 39,799 |
| Net claims incurred | (347,865) | (108,498) | (662) | (457,025) | (268,695) | (113,161) | (207) | (382,063) |
| Acquisition costs | (118,546) | (81,827) | (18,380) | (218,753) | (108,726) | (70,537) | (15,729) | (194,992) |
| Administrative expenses | (14,342) | (24,571) | (2,284) | (41,197) | (18,211) | (24,197) | (450) | (42,858) |
| Other income/(expenses) | 55,060 | 2,362 | (162) | 57,260 | (32,996) | 1,067 | (649) | (32,578) |
| Trading result | 38,822 | 43,369 | 3,506 | 85,697 | 83,341 | 16,914 | 1,905 | 102,160 |
| Agency and other income | 8,376 | 22,640 | 2,469 | 33,485 | 7,138 | 22,535 | 618 | 30,291 |
| Profit commission | 7,357 | – | – | 7,357 | 3,539 | (31) | – | 3,508 |
| Short-term investment return fluctuations | (15,252) | 6,081 | (70) | (9,241) | (8,044) | 2,733 | (56) | (5,367) |
| Other expenses | (15,253) | (28,740) | – | (43,993) | (16,187) | (23,296) | – | (39,483) |
| Operating result | 24,050 | 43,350 | 5,905 | 73,305 | 69,787 | 18,855 | 2,467 | 91,109 |
| Finance costs | (3,334) | – | – | (3,334) | (1,977) | – | – | (1,977) |
| Associates result | – | – | 250 | 250 | – | – | 390 | 390 |
| Profit before tax | 20,716 | 43,350 | 6,155 | 70,221 | 67,810 | 18,855 | 2,857 | 89,522 |

The longer term rates of return are calculated based on a 6% return on equities and 4% for all other investments including cash. These rates are applied to the average value of investments held in each class during the current and prior financial year.

The following charges are included within the income statement:

| | Year to 31 December 2005 | | | | Year to 31 December 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe* £000 | International £000 | Total £000 | Global Markets and Corporate Centre £000 | UK and Europe* £000 | International £000 | Total £000 |
| Depreciation | 1,318 | 1,963 | – | 3,281 | 1,148 | 1,690 | 96 | 2,934 |
| Amortisation of intangible assets | 47 | 120 | – | 167 | – | – | – | – |
| Impairment loss on investment in associate | 182 | – | – | 182 | – | – | – | – |

*The majority of all UK based tangible assets, and their related financing arrangements, have been accounted for and are held by entities in the Global Markets and Corporate Centre segment. The UK and Europe business benefits from certain operational facilities and other tangible assets shared with the Global Market and Corporate Centre segment. The depreciation cost reflected for the UK and Europe segment is that primarily recharged internally by the Global Markets and Corporate Centre segment.

### 100% Ratio analysis

| | Year to 31 December 2005 | | | | Year to 31 December 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre | UK and Europe | International | Total | Global Markets and Corporate Centre | UK and Europe | International | Total |
| Claims ratio (%) | 70.8 | 45.1 | 2.8 | 61.8 | 72.9 | 55.1 | 1.1 | 67.5 |
| Expense ratio (%) | 29.1 | 41.8 | 88.5 | 34.2 | 18.0 | 42.9 | 90.9 | 25.1 |
| Combined ratio (%) | 99.9 | 86.9 | 91.3 | 96.0 | 90.9 | 98.0 | 92.0 | 92.6 |

In calculating the claims and expense ratios the Group has applied an estimated allocation of the foreign exchange gains and losses to each category.

## 5 Segmental information continued

The impact of a 1% change in each component of the segmental combined ratios are:

| | Year to 31 December 2005 | | | Year to 31 December 2004 | | |
|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 |
| At 100% level (note 5c) | | | | | | |
| 1% change in claims or expense ratio | 6,268 | 2,565 | 234 | 7,436 | 2,304 | 185 |
| At Group level | | | | | | |
| 1% change in claims or expense ratio | 4,289 | 2,416 | 234 | 4,826 | 2,124 | 185 |

### (b) Reconciliation of 100% level to Group results

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Trading result based on longer term rates of return at 100% level (note 5c) | 102,381 | 119,507 |
| Notional share attributable to Group at current level of capacity ownership | 93,872 | 100,438 |
| Adjustment to reflect different levels of capacity in prior years: | | |
| 2001 year of account | – | (184) |
| 2002 year of account | – | 223 |
| 2003 year of account | (2,505) | 33 |
| 2004 year of account | (5,670) | – |
| Amounts attributable to quota share reinsurers | – | 1,650 |
| Trading result based on longer term rates of return for the Group (note 5a) | 85,697 | 102,160 |

For the 2005 year of account the Group owned 71% (2004: 65%) of the Syndicate. For the 2002 year of account, 8% of the capacity (2001 year of account: 7%) was reinsured to three leading European insurers via a quota share arrangement.

### (c) 100% level underwriting results by segment

| | Year to 31 December 2005 | | | | Year to 31 December 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 |
| Gross premiums written | 786,347 | 274,886 | 43,720 | 1,104,953 | 785,513 | 288,092 | 37,317 | 1,110,922 |
| Net premiums written | 584,132 | 245,823 | 28,832 | 858,787 | 760,966 | 251,340 | 19,465 | 1,031,771 |
| Net premiums earned | 626,784 | 256,472 | 23,362 | 906,618 | 743,645 | 230,374 | 18,526 | 992,545 |
| Investment result based on longer term rates of return | 51,287 | 14,300 | 1,632 | 67,219 | 34,018 | 11,374 | 414 | 45,806 |
| Net claims incurred | (504,042) | (115,659) | (662) | (620,363) | (412,874) | (126,834) | (207) | (539,915) |
| Acquisition costs | (174,189) | (87,501) | (18,380) | (280,070) | (175,018) | (76,558) | (15,729) | (267,305) |
| Administrative expenses | (30,777) | (25,385) | (2,284) | (58,446) | (30,106) | (25,531) | (450) | (56,087) |
| Other income/(expenses) | 83,887 | 3,536 | – | 87,423 | (55,955) | 1,067 | (649) | (55,537) |
| Trading result based on longer term rates of return | 52,950 | 45,763 | 3,668 | 102,381 | 103,710 | 13,892 | 1,905 | 119,507 |

# Notes to the financial statements continued

## 5 Segmental information continued

### (d) Segmental analysis of assets and liabilities

The segment assets and liabilities at 31 December and the capital expenditure for the year then ended are as follows:

| | Year to 31 December 2005 | | | | | Year to 31 December 2004 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Eliminations and unallocated items £000 | Total £000 | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Eliminations and unallocated items £000 | Total £000 |
| Financial assets | 907,295 | 319,460 | 11,023 | – | 1,237,778 | 745,351 | 231,031 | 4,349 | – | 980,731 |
| Reinsurance assets | 426,718 | 67,177 | 12,481 | – | 506,376 | 156,504 | 69,415 | 12,952 | – | 238,871 |
| Intangible assets | 30,144 | 2,955 | – | – | 33,099 | 29,315 | 674 | – | – | 29,989 |
| Deferred acquisition costs | 59,587 | 36,456 | 10,704 | – | 106,747 | 65,005 | 36,403 | 8,562 | – | 109,970 |
| Other assets | 485,467 | 163,111 | 316,473 | (102,165) | 862,886 | 346,760 | 167,628 | 19,084 | (74,627) | 458,845 |
| Total assets | 1,909,211 | 589,159 | 350,681 | (102,165) | 2,746,886 | 1,342,935 | 505,151 | 44,947 | (74,627) | 1,818,406 |
| Insurance liabilities | 1,339,838 | 353,110 | 30,052 | – | 1,723,000 | 897,615 | 326,091 | 23,197 | – | 1,246,903 |
| Other liabilities | 369,415 | 134,218 | 12,631 | (70,391) | 445,873 | 126,433 | 115,549 | 12,953 | (52,258) | 202,677 |
| Total liabilities | 1,709,253 | 487,328 | 42,683 | (70,391) | 2,168,873 | 1,024,048 | 441,640 | 36,150 | (52,258) | 1,449,580 |
| Capital expenditure | 5,012 | 2,696 | 388 | – | 8,096 | 9,709 | 70 | – | – | 9,779 |

Segment assets and liabilities primarily consist of operating assets and liabilities, which represent the majority of the balance sheet. Inter-segmental assets and liabilities, together with taxation balances that are not allocated to specific segments, are presented under the separate category headed 'Eliminations and unallocated items'.

Capital expenditure comprises additions to property, plant and equipment (note 15) and intangible assets (note 16).

### (e) Secondary reporting format – geographical segments

The Group's operational segments underwrite business from locations in the UK and Ireland, and also through its branch network in Guernsey, France, Germany, Belgium and the Netherlands. The Group commenced underwriting and agency operations in Bermuda and the USA in 2006.

The following table provides an analysis of the Group's gross insurance premium earned by geographical location of policyholders:

Gross earned premiums

| | Year to 31 December 2005 | | | | Year to 31 December 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 |
| UK and Ireland | 99,916 | 207,338 | 2,449 | 309,703 | 98,515 | 178,362 | 328 | 277,205 |
| Europe | 51,504 | 55,616 | 8,841 | 115,961 | 56,117 | 51,457 | 7,750 | 115,324 |
| United States | 308,794 | 8,773 | 1,558 | 319,125 | 303,228 | 10,766 | 1,651 | 315,645 |
| Rest of World | 105,401 | 2,654 | 26,500 | 134,555 | 109,499 | 3,186 | 26,665 | 139,350 |
| | 565,615 | 274,381 | 39,348 | 879,344 | 567,359 | 243,771 | 36,394 | 847,524 |

## 5 Segmental information continued

(e) Secondary reporting format – geographical segments continued

The following tables provide an analysis of total segment assets at the end of the year, and capital expenditure incurred during the year, by geographical location. Capital expenditure relates to the acquisition of intangible assets and property, plant and equipment during the year. Amounts are stated before the elimination of inter-segmental assets and liabilities and also exclude taxation balances that are not allocated to specific segments (note 5(d)). Amounts are allocated based on where the assets are located.

### Total segment assets

| | At 31 December 2005 | | | | At 31 December 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 |
| UK and Ireland | 1,909,211 | 556,880 | 57,599 | 2,523,690 | 1,342,935 | 465,808 | 44,947 | 1,853,690 |
| Europe | – | 32,279 | – | 32,279 | – | 39,343 | – | 39,343 |
| United States | – | – | 508 | 508 | – | – | – | – |
| Bermuda | – | – | 292,574 | 292,574 | – | – | – | – |
| | 1,909,211 | 589,159 | 350,681 | 2,849,051 | 1,342,935 | 505,151 | 44,947 | 1,893,033 |

### Capital expenditure

| | At 31 December 2005 | | | | At 31 December 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 | Global Markets and Corporate Centre £000 | UK and Europe £000 | International £000 | Total £000 |
| UK and Ireland | 5,012 | 2,401 | – | 7,413 | 9,709 | – | – | 9,709 |
| Europe | – | 295 | – | 295 | – | 70 | – | 70 |
| United States | – | – | 118 | 118 | – | – | – | – |
| Bermuda | – | – | 270 | 270 | – | – | – | – |
| | 5,012 | 2,696 | 388 | 8,096 | 9,709 | 70 | – | 9,779 |

## 6 Net asset value per share

| | 2005 Net asset value £000 | 2005 NAV per share pence | 2004 Net asset value £000 | 2004 NAV per share pence |
|---|---|---|---|---|
| Net asset value | 578,013 | 147.7 | 368,826 | 125.7 |
| Net tangible asset value | 544,914 | 139.3 | 338,837 | 115.5 |

The net asset value per share is based on 391,216,294 shares (2004: 293,305,922), being the adjusted number of shares in issue at 31 December.

## 7 Investment result

The total investment return for the Group before taxation comprises:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Investment income including interest receivable | 48,172 | 35,051 |
| Net realised losses on investments at fair value through profit or loss | (8,040) | (6,608) |
| Net fair value gains on investments at fair value through profit or loss | 10,155 | 6,015 |
| Return on investments (note 8) | 50,287 | 34,458 |
| Fair value gains/(losses) on derivative instruments (note 21) | (6,404) | 1,348 |
| Total return on financial assets | 43,883 | 35,806 |

## 8 Analysis of return on investments

The return on investments for the year by currency was:

| | 2005 % | 2004 % |
|---|---|---|
| Sterling | 6.1 | 5.5 |
| US Dollar | 2.5 | 1.6 |
| Other | 2.2 | 2.8 |

The return on investments by asset class for the year was:

| | Global Markets and Corporate Centre £000 | % | UK and Europe £000 | % | International £000 | % | 2005 Total £000 | % |
|---|---|---|---|---|---|---|---|---|
| Debt and fixed income securities at fair value through income | 20,627 | 2.9 | 5,992 | 4.4 | 114 | 1.7 | 26,733 | 3.1 |
| Equities and shares in unit trusts at fair value through income | 4,294 | 10.8 | 7,524 | 15.2 | 460 | 10.8 | 12,278 | 13.1 |
| Deposits with credit institutions/cash and cash equivalents | 3,855 | 2.9 | 6,434 | 4.4 | 987 | 3.5 | 11,276 | 3.7 |
| | 28,776 | 3.2 | 19,950 | 6.0 | 1,561 | 4.0 | 50,287 | 4.0 |

| | Global Markets and Corporate Centre £000 | % | UK and Europe £000 | % | International £000 | % | 2004 Total £000 | % |
|---|---|---|---|---|---|---|---|---|
| Debt and fixed income securities at fair value through income | 14,703 | 2.6 | 5,473 | 4.9 | – | – | 20,176 | 2.9 |
| Equities and shares in unit trusts at fair value through income | 3,409 | 9.0 | 4,853 | 11.2 | 309 | 5.7 | 8,571 | 10.3 |
| Deposits with credit institutions/cash and cash equivalents | 1,799 | 2.3 | 3,863 | 3.6 | 49 | 1.3 | 5,711 | 3.0 |
| | 19,911 | 2.9 | 14,189 | 5.6 | 358 | 3.9 | 34,458 | 3.6 |

## 9 Insurance contract acquisition costs

| | 2005 Gross £000 | 2005 Reinsurance £000 | 2005 Net £000 | 2004 Gross £000 | 2004 Reinsurance £000 | 2004 Net £000 |
|---|---|---|---|---|---|---|
| Balance deferred at 1 January | 109,970 | (4,552) | 105,418 | 99,374 | (9,399) | 89,975 |
| Acquisition costs incurred in relation to insurance contracts written | 203,289 | (4,477) | 198,812 | 192,601 | 802 | 193,403 |
| Acquisition costs expensed to the income statement | (206,512) | 6,533 | (199,979) | (182,005) | 4,045 | (177,960) |
| Balance deferred at 31 December | 106,747 | (2,496) | 104,251 | 109,970 | (4,552) | 105,418 |

The deferred amount of insurance contract acquisition costs attributable to reinsurers of £2,496,000 (2004: £4,552,000) is not eligible for offset against the gross balance sheet asset and is included separately within accruals and deferred income (note 26).

## 10 Other operating income and expenses

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Agency related income | 3,044 | 6,212 |
| Profit commission | 9,807 | 3,508 |
| Exchange gains | 57,420 | – |
| Other income | 11,026 | 5,392 |
| Other income | 81,297 | 15,112 |
| Managing agency expenses | 9,869 | 7,447 |
| Overseas underwriting agency expenses | 19,886 | 21,101 |
| Connect agency expenses | 6,135 | 2,155 |
| Exchange losses | – | 35,576 |
| Investment expenses | 1,013 | 1,374 |
| Other Group expenses | 10,070 | 3,787 |
| Other operating expenses | 46,973 | 71,440 |

## 11 Employee benefit expense

The aggregate remuneration and associated costs were:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Wages and salaries, including holiday pay and sabbatical leave charges | 37,581 | 31,900 |
| Social security costs | 6,124 | 4,645 |
| Share based payments cost of options granted to Directors and employees (note 23) | 2,059 | 1,194 |
| Pension costs – defined contribution | 825 | 669 |
| Pension costs – net expense arising on defined benefit plans (note 29) | 4,047 | 4,457 |
| Other employment benefits | – | – |
| | 50,636 | 42,865 |

The average monthly number of staff employed by the Group was 514 (2004: 446) comprising 190 underwriting and 324 administrative staff (2004: 154 and 292 respectively). Of the total remuneration shown above, an amount of £14,433,000 (2004: £13,697,000) was recharged to the syndicate managed by Hiscox Syndicates Limited. The Company had no employees in the current or prior financial year.

## 12 Finance costs

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Expense associated with letters of credit and other bank borrowing facilities (note 33) | 3,302 | 1,952 |
| Interest charges arising on finance leases | 32 | 25 |
| | 3,334 | 1,977 |

## 13 Auditors' remuneration

Fees payable to the auditors and its associates (exclusive of VAT) include the following amounts recorded in the income statement:

(a) Group

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Audit and assurance services: | | |
| Statutory audit fee | 305 | 230 |
| Regulatory audit fee | 25 | 15 |
| Other* | 53 | – |
| | 383 | 245 |
| Other non-audit services**: | | |
| Work performed in relation to corporate projects* | 211 | 5 |
| | 211 | 5 |
| Total auditors' remuneration expense | 594 | 250 |

*Other assurance fees include work performed in relation to the establishment of the Group's Bermudan operation and also the Group's transition to IFRSs. Other non-audit fees include work performed in relation to the establishment of the Group's Bermudan operation.

**Non-audit services with fees greater than £50,000 must be pre-approved by the Audit Committee which is composed solely of independent non executive directors.

# Notes to the financial statements continued

## 13 Auditors' remuneration continued

(b) Company

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Audit and assurance services: | | |
| Statutory audit fee | 115 | 119 |
| Regulatory audit fee | – | – |
| | 115 | 119 |
| Other non-audit services*: | | |
| Work performed in relation to corporate projects | – | – |
| | – | – |
| Total auditors' remuneration expense | 115 | 119 |

*Non-audit services with fees greater than £50,000 must be pre-approved by the Audit Committee which is composed solely of independent non executive directors.

KPMG Audit Plc acted as auditors to the Group during the current and previous financial year. KPMG Audit Plc were also appointed as auditors to Syndicate 33 during the current financial year under review. The full fee payable for the Syndicate audit has been included for 2005 above, although an element of this is borne by the third-party participants in the Syndicate.

In addition to the above expenses, the auditors also earned fees of £245,000 exclusive of VAT (2004: nil) in relation to the Group's Rights Issue which have been deducted from the share premium reserve (note 23).

## 14 Net foreign exchange gains

The net foreign exchange gains/(losses) for the year include the following amounts:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Exchange gains/(losses) recognised in the income statement | 57,420 | (35,576) |
| Exchange gains/(losses) classified as a separate component of equity | 1,290 | (468) |

This excludes profits or losses on foreign exchange derivative contracts which are outlined in note 21.

## 15 Property, plant and equipment

(a) Group

| | Land and buildings £000 | Leasehold improvements £000 | Vehicles £000 | Furniture, fittings, equipment and art £000 | Total £000 |
|---|---|---|---|---|---|
| At 1 January 2004 | | | | | |
| Cost | 407 | – | 1,060 | 17,353 | 18,820 |
| Accumulated depreciation | – | – | (789) | (10,281) | (11,070) |
| Net book amount | 407 | – | 271 | 7,072 | 7,750 |
| Year ended 31 December 2004 | | | | | |
| Opening net book amount | 407 | – | 271 | 7,072 | 7,750 |
| Additions | 2,985 | – | 307 | 3,081 | 6,373 |
| Disposals | (407) | – | (91) | – | (498) |
| Depreciation charge | (40) | – | (92) | (2,802) | (2,934) |
| Closing net book amount | 2,945 | – | 395 | 7,351 | 10,691 |
| At 31 December 2004 | | | | | |
| Cost | 2,985 | – | 508 | 20,430 | 23,923 |
| Accumulated depreciation | (40) | – | (113) | (13,079) | (13,232) |
| Net book amount | 2,945 | – | 395 | 7,351 | 10,691 |

## 15 Property, plant and equipment continued

### (a) Group continued

| | Land and buildings £000 | Leasehold improvements £000 | Vehicles £000 | Furniture, fittings and equipment and art £000 | Total £000 |
|---|---|---|---|---|---|
| Year ended 31 December 2005 | | | | | |
| Opening net book amount | 2,945 | – | 395 | 7,351 | 10,691 |
| Additions | – | 6 | 217 | 4,596 | 4,819 |
| Disposals | – | – | (36) | (65) | (101) |
| Depreciation charge | (40) | – | (100) | (3,141) | (3,281) |
| Closing net book amount | 2,905 | 6 | 476 | 8,741 | 12,128 |
| At 31 December 2005 | | | | | |
| Cost | 2,985 | 6 | 647 | 24,925 | 28,563 |
| Accumulated depreciation | (80) | – | (171) | (16,184) | (16,435) |
| Net book amount | 2,905 | 6 | 476 | 8,741 | 12,128 |

The Group's land and buildings assets relate to freehold property in the United Kingdom. At 31 December 2005 and 2004 part of the buildings were occupied by third parties under separate operating lease arrangements (note 34).

Assets with a net book value of £476,000 were held under finance leases (2004: £397,000). The total depreciation charge for the year in respect of assets held under finance leases was £100,000 (2004: £86,000). The Company held no assets under finance leases during the current or prior year.

### (b) Company

| | Land and buildings £000 | Art £000 | Total £000 |
|---|---|---|---|
| At 1 January 2004 | | | |
| Cost | – | 592 | 592 |
| Accumulated depreciation | – | – | – |
| Net book amount | – | 592 | 592 |
| Year ended 31 December 2004 | | | |
| Opening net book amount | – | 592 | 592 |
| Additions | 2,985 | 34 | 3,019 |
| Disposals | – | – | – |
| Depreciation charge | (40) | – | (40) |
| Closing net book amount | 2,945 | 626 | 3,571 |
| At 31 December 2004 | | | |
| Cost | 2,985 | 626 | 3,611 |
| Accumulated depreciation | (40) | – | (40) |
| Net book amount | 2,945 | 626 | 3,571 |
| Year ended 31 December 2005 | | | |
| Opening net book amount | 2,945 | 626 | 3,571 |
| Additions | – | 225 | 225 |
| Disposals | – | (47) | (47) |
| Depreciation charge | (40) | – | (40) |
| Closing net book amount | 2,905 | 804 | 3,709 |
| At 31 December 2005 | | | |
| Cost | 2,985 | 804 | 3,789 |
| Accumulated depreciation | (80) | – | (80) |
| Net book amount | 2,905 | 804 | 3,709 |

The Company's land and buildings assets relate to freehold property in the United Kingdom. At 31 December 2005 and 2004 part of the buildings were occupied by third parties under separate operating lease arrangements (note 34).

## 16 Intangible assets

| Group | Goodwill £000 | Syndicate capacity £000 | Other £000 | Total £000 |
|---|---|---|---|---|
| At 1 January 2004 | | | | |
| Cost | 8,547 | 20,343 | 149 | 29,039 |
| Accumulated amortisation and impairment | (2,442) | – | (14) | (2,456) |
| Net book amount | 6,105 | 20,343 | 135 | 26,583 |
| Year ended 31 December 2004 | | | | |
| Opening net book amount | 6,105 | 20,343 | 135 | 26,583 |
| Additions in year | – | 3,286 | 120 | 3,406 |
| Closing net book amount | 6,105 | 23,629 | 255 | 29,989 |
| At 1 January 2005 | | | | |
| Cost | 8,547 | 23,629 | 269 | 32,445 |
| Accumulated amortisation and impairment | (2,442) | – | (14) | (2,456) |
| Net book amount | 6,105 | 23,629 | 255 | 29,989 |
| Year ended 31 December 2005 | | | | |
| Opening net book amount | 6,105 | 23,629 | 255 | 29,989 |
| Additions in year | – | 876 | 2,401 | 3,277 |
| Amortisation and impairment charge | – | – | (167) | (167) |
| Closing net book amount | 6,105 | 24,505 | 2,489 | 33,099 |
| At 31 December 2005 | | | | |
| Cost | 8,547 | 24,505 | 2,670 | 35,722 |
| Accumulated amortisation and impairment | (2,442) | – | (181) | (2,623) |
| Net book amount | 6,105 | 24,505 | 2,489 | 33,099 |

The additions to syndicate capacity during 2005 and 2004 represent the amounts paid, inclusive of transaction costs, by the Group in acquiring an additional 1% of capacity of Syndicate 33 in open market auctions (2004: 6%). The Group's intangible asset relating to syndicate capacity has been allocated, for impairment testing purposes, to one individual cash generating unit being the Lloyd's corporate member entities. The Group has considered the recoverable amount from the Lloyd's corporate member entities on a value in use basis. This calculation uses cash flow projections based on financial forecasts approved by management covering a five year period. Cash flows beyond the five year period are extrapolated based on an average level of return and annual growth. The results of this exercise indicate that the recoverable amount exceeds the intangible's carrying value.

Other intangibles primarily relate to the costs of acquiring rights to customer contractual relationships and also include a limited level of capitalised software costs. The additions during the year primarily comprise the Group's acquisition of the business of Insurex Expo-Sure in February 2005.

The amortisation charge for the year includes £40,000 (2004: £nil) relating to capitalised software costs. The net book value of capitalised software costs at 31 December 2005 was £80,000 (2004: £120,000). There are no charges for impairment during the current or prior financial year.

The Group had no internally generated intangible assets at 31 December 2005 (2004: £nil).

Goodwill is allocated to the Group's cash generating units ('CGUs') identified according to country of operation and business segment.
At 31 December 2005 and 2004 the Group's goodwill balances are all attributable to UK based operations.

## 17 Investments in associates

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Year ended 31 December | | | | |
| At beginning of year | 1,109 | 519 | 200 | – |
| Investments acquired during year | – | 200 | – | 200 |
| Investments disposed of during year | (1,159) | – | – | – |
| Share of post tax profit for the period until disposal | 250 | 390 | – | – |
| Provision for impairment | (182) | | (182) | |
| At end of year | 18 | 1,109 | 18 | 200 |

The Group's interests in its principal associates, all of which are unlisted, were as follows:

| Name | % interest held at 31 December | Country of incorporation | Assets £000 | Liabilities £000 | Revenues £000 | Profit/ (loss) £000 |
|---|---|---|---|---|---|---|
| Heritage Group Ltd | 49.9 | Guernsey | 12,481 | 10,650 | 11,996 | 920 |
| Blyth Valley Ltd | 25.2 | UK | 190 | 94 | 462 | (78) |
| Total at the end of 2004 | | | 12,671 | 10,744 | 12,458 | 842 |
| Blyth Valley Ltd | 25.2 | UK | 160 | 87 | 512 | (11) |
| Total at the end of 2005 | | | 160 | 87 | 512 | (11) |

The equity interest held by the Group in respect of the associate does not have a quoted market price and are not traded in any active market. Consequently its fair value cannot be reliably measured with any degree of certainty. An impairment charge of £182,000 (2004: nil) was recognised in profit or loss during the year.

The Group sold its investment in Heritage Group Limited on 11 July 2005 for a net consideration of £3,750,000. The gain arising on disposal of £2,591,000 is included within the other income (note 10).

The Company's investment in associate at 31 December 2005 relates solely to its 25.2% holding in the ordinary share capital of Blyth Valley Ltd.

## 18 Reinsurance assets

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Reinsurers' share of insurance liabilities | 514,248 | 248,554 |
| Provision for non recovery and impairment | (7,872) | (9,683) |
| Total assets arising from reinsurance contracts | 506,376 | 238,871 |

| The amounts expected to be recovered before and after one year, based on historical experience, are estimated as follows: | | |
|---|---|---|
| Within one year | 189,258 | 117,137 |
| After one year | 317,118 | 121,734 |
| | 506,376 | 238,871 |

Amounts due from reinsurers in respect of outstanding premiums, and claims already paid by the Group are included in loans and receivables (note 20).

# Notes to the financial statements continued

## 19 Financial assets and liabilities

Financial assets and liabilities are all measured at their bid price fair values with all changes from one accounting period to the next being recorded through the income statement as provided for by IAS 39.

| | Group | | | | Company | | | |
|---|---|---|---|---|---|---|---|---|
| | 2005 Cost £000 | 2005 Fair value £000 | 2004 Cost £000 | 2004 Fair value £000 | 2005 Cost £000 | 2005 Fair value £000 | 2004 Cost £000 | 2004 Fair value £000 |
| Debt and fixed income securities | 1,036,335 | 1,028,795 | 839,082 | 833,963 | 95,279 | 95,339 | 96,567 | 96,249 |
| Equities and shares in unit trusts | 101,895 | 119,407 | 80,065 | 86,783 | 44,555 | 48,972 | 38,338 | 39,985 |
| Deposits with credit institutions | 89,532 | 89,576 | 58,640 | 58,637 | 634 | 634 | – | – |
| Total investments | 1,227,762 | 1,237,778 | 977,787 | 979,383 | 140,468 | 144,945 | 134,905 | 136,234 |
| Derivative instrument assets (note 21) | – | – | – | 1,348 | – | – | – | 1,348 |
| Total financial assets | 1,227,762 | 1,237,778 | 977,787 | 980,731 | 140,468 | 144,945 | 134,905 | 137,582 |

| | Group | | | | Company | | | |
|---|---|---|---|---|---|---|---|---|
| | 2005 Cost £000 | 2005 Fair value £000 | 2004 Cost £000 | 2004 Fair value £000 | 2005 Cost £000 | 2005 Fair value £000 | 2004 Cost £000 | 2004 Fair value £000 |
| Short-term borrowings from credit institutions | 121,070 | 121,190 | 57 | 57 | 120,810 | 120,930 | – | – |
| Derivative instrument liabilities (note 21) | – | 5,056 | – | – | – | 5,056 | – | – |
| Total financial liabilities | 121,070 | 126,246 | 57 | 57 | 120,810 | 125,986 | – | – |

An analysis of the credit risk and contractual maturity profiles of the Group and Company's debt and fixed income securities is given in notes 4.4 and 4.5. The Group and the Company have no material exposure to financial assets not actively traded on recognised markets within their investment portfolios.

Investments at 31 December are denominated in the following currencies at their fair value:

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Debt and fixed income securities | | | | |
| Sterling | 266,771 | 224,628 | 95,339 | 96,249 |
| US Dollars | 598,834 | 462,166 | – | – |
| Euro and other currencies | 163,190 | 147,169 | – | – |
| | 1,028,795 | 833,963 | 95,339 | 96,249 |
| Equities and shares in unit trusts | | | | |
| Sterling | 93,916 | 63,787 | 39,068 | 29,089 |
| US Dollars | 24,990 | 22,996 | 9,904 | 10,896 |
| Euro and other currencies | 501 | – | – | – |
| | 119,407 | 86,783 | 48,972 | 39,985 |
| Deposits with credit institutions | | | | |
| Sterling | 89,455 | 58,637 | 634 | – |
| US Dollars | – | – | – | – |
| Euro and other currencies | 121 | – | – | – |
| | 89,576 | 58,637 | 634 | – |
| Total investments | 1,237,778 | 979,383 | 144,945 | 136,234 |

The table below illustrates the movements in financial assets during the year:

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| At 1 January | 980,731 | 750,411 | 137,582 | 99,386 |
| Net additions to investment portfolio | 246,892 | 224,305 | 2,556 | 34,957 |
| Net fair value gains/(losses) | 10,155 | 6,015 | 4,807 | 3,239 |
| At 31 December | 1,237,778 | 980,731 | 144,945 | 137,582 |

## 19 Financial assets and liabilities continued

Company investment in subsidiary undertakings

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Hiscox Insurance Company (Bermuda) Limited | 291,540 | – |
| Hiscox Dedicated Corporate Member Limited | 1,500 | 1,500 |
| Hiscox Holdings Limited | 38,647 | 38,647 |
| Hiscox Insurance Holdings Limited | 29,983 | 29,983 |
| Hiscox Select Insurance Fund PLC | 45,102 | 45,102 |
| Hiscox Investment Management Limited | 225 | 225 |
| At 31 December | 406,997 | 115,457 |

For additional details of the principal subsidiary undertakings, see note 35.

## 20 Loans and receivables

(a) Group

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Gross receivables arising from insurance and reinsurance contracts | 351,051 | 258,424 |
| Less provision for impairment | (1,018) | (869) |
| Net receivables arising from insurance and reinsurance contracts | 350,033 | 257,555 |
| | | |
| Due from contract holders, brokers, agents and intermediaries | 302,571 | 223,167 |
| Due from reinsurance operations | 47,462 | 34,388 |
| | 350,033 | 257,555 |
| Other loans and receivables: | | |
| Prepayments and accrued income | 8,632 | 8,201 |
| Net profit commission receivable | 17,410 | 11,458 |
| Accrued interest | 6,943 | 5,428 |
| Right to reimbursement of defined benefit obligation (note 29) | 5,462 | 7,345 |
| Share of syndicate's other debtors balances | 40,579 | 33,735 |
| Other debtors including related party amounts (note 36) | 7,922 | 3,760 |
| Less provision for impairment | – | – |
| Total loans and receivables including insurance receivables | 436,981 | 327,482 |

| The amounts expected to be recovered before and after one year are estimated as follows: | | |
|---|---|---|
| Within one year | 436,818 | 327,426 |
| After one year | 163 | 56 |
| | 436,981 | 327,482 |

There is no significant concentration of credit risk with respect to loans and receivables, as the Group has a large number of internationally dispersed debtors. The Group has recognised a loss of £449,000 (2004: £1,932,000) for the impairment of its receivables during the year ended 31 December 2005.

(b) Company

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Due from Group companies | 158,220 | 175,563 |
| Other debtors | 114 | 89 |
| Total | 158,334 | 175,652 |

The Company's loans and receivables are all expected to be recovered after one year.

## 21 Derivative financial instruments

The Group and the Company entered into a small number of foreign exchange cylindrical collar contracts in order to manage exposure to business denominated in a currency other than their presentational currency. At 31 December 2005 the net fair value position of the Company and the Group's derivative exposure on these contracts was a financial liability of £4,892,000 (2004: asset of £1,348,000 included within financial assets). No expenses or charges were incurred in the acquisition of the derivative contracts (2004: £nil). There were no realised gains or losses in the current or prior financial year.

| | 2005 Contract notional amounts US$000 | 2005 Fair value of assets £000 | 2005 Fair value of liabilities £000 | 2004 Contract notional amounts US$000 | 2004 Fair value of assets £000 | 2004 Fair value of liabilities £000 |
|---|---|---|---|---|---|---|
| Foreign exchange option contracts expiring: | | | | | | |
| Within one year | 160,000 | 297 | 4,010 | – | – | – |
| Between one and five years | 50,000 | 472 | 1,651 | 75,000 | 2,126 | 778 |
| After five years | – | – | – | – | – | – |
| Total at 31 December | 210,000 | 769 | 5,661 | 75,000 | 2,126 | 778 |

The Group and the Company have the right and intention to settle the above contracts on a net basis. Consequently, only the net asset or liability is recognised in the balance sheet as detailed in note 19.

The Group and the Company also entered into a foreign exchange forward contract during the year in order to manage the net investment in the Bermudan operation and currency exposures related to the proceeds raised from the Rights Issue (note 23). The contract requires the Group and the Company to sell US$292,689,000 at an agreed future rate to Pound Sterling at a fixed date within one year of the balance sheet date. At 31 December 2005, the fair value position of this contract to the Group and Company was a liability of £164,000 (2004: £nil).

## 22 Cash and cash equivalents

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Cash at bank and in hand | 370,165 | 61,332 | 1,380 | 2,222 |
| Short-term bank deposits | 43,594 | 58,231 | 10,565 | 2,961 |
| | 413,759 | 119,563 | 11,945 | 5,183 |

The short-term bank deposits of the Group and the Company have an original maturity of three months or less. The carrying amount of these assets approximates to their fair value.

## 23 Share capital and premium

| | Number of shares in issue (thousands) | Ordinary share capital £000 | Share premium £000 |
|---|---|---|---|
| At 1 January 2004 | 291,292 | 14,565 | 232,341 |
| Employee share option scheme – proceeds from shares issued | 2,407 | 120 | 1,926 |
| At 31 December 2004 | 293,699 | 14,685 | 234,267 |
| Employee share option scheme – proceeds from shares issued | 1,331 | 67 | 1,522 |
| Rights Issue of ordinary shares | 96,377 | 4,818 | 171,550 |
| Expenses related to Rights Issue | – | – | (5,974) |
| At 31 December 2005 | 391,407 | 19,570 | 401,365 |

The total authorised number of ordinary shares at 31 December 2005 was 600,000,000 (2004: 410,000,000), with a nominal value of 5p per share. The increase in authorised share capital during the year was approved by shareholders on 6 December 2005. All issued shares are fully paid. The Company issued 96,376,553 new ordinary shares at a price of 183p per share as part of the Rights Issue which was completed during November 2005.

## 23 Share capital and premium continued

The Group acquired £72,000 (2004: £109,000) and disposed of £274,000 (2004: £363,000) of the Company's own shares through transactions on the London Stock Exchange. These shares were acquired by the Group Employee Share Ownership Plan (ESOP) and those issued were to staff as part of the employee performance share plans. The net effect of transactions in own shares during the year was an increase to retained earnings of £192,000 (2004: £254,000). The Group has the right to reissue these shares at a later date. Additional details of these transactions, including the number of own shares held, are given in note 35. The Company did not hold any of its owns shares during the current or prior year.

### Share options

Share options are granted to directors and to senior employees. The exercise price of the granted options is equal to the market price of the shares on the date of the grant. Options are conditional on the employee completing three year's service (the vesting period). The options are exercisable starting three years from the grant date only if the Group achieves its targets of profitability; the options have a contractual option term of ten years. The Group has no legal or constructive obligation to repurchase or settle the options in cash.

In accordance with IFRS 2 the Group recognises an expense for the fair value of share option instruments issued to employees, over their vesting period through the income statements. The expense recognised in the Consolidated Income Statement during the year was £2,059,000 (2004: £1,194,000). The Group has conservatively applied the principles outlined in the Black Scholes option pricing model when determining the fair value of each share option instrument. The range of principal Group assumptions applied in determining the fair value of options that have not yet fully vested at 31 December are:

| Assumptions affecting inputs to options pricing model | 2005 | 2004 |
|---|---|---|
| Annual risk free rates of return (%) | 3.5-5.0 | 3.5-4.5 |
| Long-term dividend yield and growth (%) | 2.0 | 2.0 |
| Expected life of options (years) | 3.25-7.5 | 3.25-6.5 |
| Implied volatility of share price over a ten year period (%) | 32-49 | 39-49 |
| Weighted average share price (pence) | 149.5 | 152.2 |

Movements in the number of share options during the year and details of the balances outstanding at 31 December 2005 are shown at note 31.

The implied volatility assumption is based on historical data.

## 24 Retained earnings and other reserves

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Merger reserve | 4,723 | 4,723 | 58,970 | 58,970 |
| Capital redemption reserve | 33,244 | 33,244 | 33,244 | 33,244 |
| Currency translation reserve | 822 | (468) | – | – |
| Total other reserves at 31 December | 38,789 | 37,499 | 92,214 | 92,214 |
| Retained earnings at 31 December | 118,289 | 82,375 | 26,369 | 18,631 |

The merger reserve reflects the net premium on shares issued as part of several business combinations which occurred in 1996 and 1998.

The capital redemption reserve arises from the redemption of some of the Company's issued share capital. These redemptions occurred in prior financial years. The purpose of establishing the capital redemption reserve is to maintain the level of equity represented by contributed capital.

The currency translation reserve comprises foreign exchange differences arising from the translation of the financial statements of, and investments in, foreign operations.

Included within retained earnings is an amount of £17,941,000 (2004: £17,941,000), which is not distributable and is held to meet solvency capital requirements to maintain an equalisation reserve. The amounts in the equalisation reserve are realised when particular entities in the Group have suffered insurance losses in excess of levels set out in the relevant solvency capital regulations.

## 25 Insurance liabilities and reinsurance assets

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Gross | | |
| Claims reported and loss adjustment expenses | 815,307 | 478,050 |
| Claims incurred but not reported | 507,186 | 352,631 |
| Unearned premiums | 400,507 | 416,222 |
| Total insurance liabilities, gross | 1,723,000 | 1,246,903 |
| Recoverable from reinsurers | | |
| Claims reported and loss adjustment expenses | 281,746 | 125,186 |
| Claims incurred but not reported | 186,054 | 70,544 |
| Unearned premiums | 38,576 | 43,141 |
| Total reinsurers' share of insurance liabilities (note 18) | 506,376 | 238,871 |
| Net | | |
| Claims reported and loss adjustment expenses | 533,561 | 352,864 |
| Claims incurred but not reported | 321,132 | 282,087 |
| Unearned premiums | 361,931 | 373,081 |
| Total insurance liabilities, net | 1,216,624 | 1,008,032 |

The amounts expected to be earned and settled before and after one year, based on historical experience, are estimated as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Within one year | 628,383 | 536,463 |
| After one year | 588,241 | 471,569 |
| | 1,216,624 | 1,008,032 |

The gross claims reported, the loss adjustment expenses liabilities and the liability for claims incurred but not reported are net of expected recoveries from salvage and subrogation. The amounts for salvage and subrogation at the end of 2005 and 2004 are not material.

### 25.1 Insurance contracts assumptions

#### (a) Process used to decide on assumptions

The risks associated with insurance contracts and in particular with casualty insurance contracts are complex and subject to a number of variables that complicate quantitative sensitivity analysis.

For all risks, the Group uses several statistical methods to incorporate the various assumptions made in order to estimate the ultimate cost of claims. The reserves for outstanding claims are actuarially estimated primarily by using both the Chain Ladder and Bornhuetter-Ferguson methods. There is close communication between the actuaries involved in the estimation process and the Group's underwriters to ensure that, when applying both estimation techniques, both parties are cognisant of all material factors relating to outstanding claims, and allowance is also made for the rating environment.

The Chain Ladder method is adopted for mature classes of business where sufficient claims development data is available in order to produce estimates of the ultimate claims and premiums by actuarial reserving Group and underwriting year or year of account for the managed syndicate. This methodology produces optimal estimates when a large claims development history is available and the claims development patterns throughout the earliest years are stable.

Where losses in the earliest underwriting years or years of account have yet to fully develop, a 'tail' arises on the reserving data, i.e. a gap between the current stage of development and the fully developed amount. The Chain Ladder methodology is used to calculate average development factors which, by fitting these development factors to a curve, allows an estimate to be made of the potential claims development expected between the current and the fully developed amount, known as a 'tail reserve'. This tail reserve is added to the current reserve position to calculate the total reserve required.

Chain Ladder methods may be applied to premiums, paid claims or incurred claims (i.e. paid claims plus case estimates). The basic technique involves the analysis of historical claims development factors and the selection of estimated development factors based on this historical pattern. The selected development factors are then applied to cumulative claims data for each accident year that is not yet fully developed to produce an estimated ultimate claims cost for each accident year.

Chain Ladder techniques are less suitable in cases in which the insurer does not have developed claims history data for a particular class of business (e.g. in relation to more recent underwriting years or years of account). In these instances the Group's actuaries make reference to the Bornhuetter-Ferguson method.

The Bornhuetter-Ferguson method is based on the Chain Ladder approach but utilises estimated ultimate loss ratios. This method uses a combination of a benchmark or market-based estimate and an estimate based on claims experience. The former is based on a measure of exposure such as premiums; the latter is based on the paid or incurred claims to date. The two estimates are combined using a formula that gives more weight to the experience-based estimate as time passes. This technique has been used in situations in which developed claims experience was not available for the projection (recent accident years or new classes of business).

In exceptional cases the required provision is calculated with reference to the actual exposures on individual policies.

### 25.1 Insurance contracts assumptions continued

Adjustments are made within the claims reserving methodologies to remove distortions in the historical claims development patterns from large or isolated claims not expected to reoccur in the future. In addition, the reserves determined for the managed syndicate are converted to annually accounted figures using earnings patterns that are consistent with those for the underlying syndicate business.

The choice of selected results for each accident year of each class of business depends on an assessment of the technique that has been most appropriate to observed historical developments. In certain instances, this has meant that different techniques or combination of techniques have been selected for individual accident years or groups of accident years within the same class of business.

### (b) Claims development tables

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The Group analyses actual claims development compared with previous estimates on an accident year basis. This exercise is performed to include the liabilities of Syndicate 33 at the 100% level regardless of the Group's actual level of ownership, which has increased significantly over the last five years. Analysis at the 100% level is required in order to avoid distortions arising from reinsurance to close arrangements which subsequently increase the Group's share of ultimate claims for each accident year three years after the end of that accident year.

The top half of each table illustrates how estimates of ultimate claim costs for each accident year have changed at successive year-ends. The bottom half reconciles cumulative claim costs to the amounts still recognised as liabilities. A reconciliation of the liability at the 100% level to the Group's share, as included in the Group balance sheet, is also shown.

Insurance claims – gross at 100% level

| Accident year | 2001 £000 | 2002 £000 | 2003 £000 | 2004 £000 | 2005 £000 | Total £000 |
|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs as adjusted for foreign exchange*: | | | | | | |
| at end of accident year | 665,949 | 378,178 | 423,768 | 645,822 | 1,061,574 | 3,175,291 |
| one year later | 651,191 | 402,673 | 436,832 | 718,460 | – | 2,209,156 |
| two years later | 721,274 | 408,262 | 411,662 | – | – | 1,541,198 |
| three years later | 743,075 | 393,389 | – | – | – | 1,136,464 |
| four years later | 780,660 | – | – | – | – | 780,660 |
| Current estimate of cumulative claims | 780,660 | 393,389 | 411,662 | 718,460 | 1,061,574 | 3,365,745 |
| Cumulative payments to date | (570,122) | (262,890) | (258,532) | (357,584) | (151,147) | (1,600,275) |
| Liability recognised at 100% level | 210,538 | 130,499 | 153,130 | 360,876 | 910,427 | 1,765,470 |
| Liability in respect of prior accident years at 100% level | | | | | | 82,193 |
| Total gross liability at 100% level | | | | | | 1,847,663 |

Reconciliation of amounts disclosed at 100% level to liability disclosed in the Group's balance sheet

| Accident year | 2001 £000 | 2002 £000 | 2003 £000 | 2004 £000 | 2005 £000 | Total £000 |
|---|---|---|---|---|---|---|
| Current estimate of cumulative claims | 780,660 | 393,389 | 411,662 | 718,460 | 1,061,574 | 3,365,745 |
| Attributable to external names | (244,919) | (101,987) | (114,132) | (206,100) | (282,883) | (950,021) |
| Group share of current estimate of cumulative claims | 535,741 | 291,402 | 297,530 | 512,360 | 778,691 | 2,415,724 |
| Cumulative payments to date | (570,122) | (262,890) | (258,532) | (357,584) | (151,147) | (1,600,275) |
| Attributable to external names | 172,850 | 62,572 | 68,215 | 104,519 | 37,275 | 445,431 |
| Group share of cumulative payments | (397,272) | (200,318) | (190,317) | (253,065) | (113,872) | (1,154,844) |
| Liability for 2001 to 2005 accident years recognised on Group's balance sheet | 138,469 | 91,084 | 107,213 | 259,295 | 664,819 | 1,260,880 |
| Liability for accident years before 2001 recognised on Group's balance sheet | – | – | – | – | – | 61,613 |
| Total Group liability – gross** | | | | | | 1,322,493 |

*The foreign exchange adjustment arises from the retranslation of the estimates at each date using the exchange rate ruling at 31 December 2005.

**This represents the claims element of the Group's insurance liabilities.

### 25.1 Insurance contracts assumptions continued

Insurance claims – net at 100% level

| Accident year | 2001 £000 | 2002 £000 | 2003 £000 | 2004 £000 | 2005 £000 | Total £000 |
|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs as adjusted for foreign exchange*: | | | | | | |
| at end of accident year | 334,022 | 252,224 | 334,122 | 540,776 | 645,835 | 2,106,979 |
| one year later | 375,679 | 273,613 | 352,261 | 570,186 | – | 1,571,739 |
| two years later | 446,385 | 287,307 | 323,048 | – | – | 1,056,740 |
| three years later | 485,328 | 267,929 | – | – | – | 753,257 |
| four years later | 472,594 | – | – | – | – | 472,594 |
| Current estimate of cumulative claims | 472,594 | 267,929 | 323,048 | 570,186 | 645,835 | 2,279,592 |
| Cumulative payments to date | (312,926) | (167,841) | (212,095) | (294,764) | (127,075) | (1,114,701) |
| Liability recognised at 100% level | 159,668 | 100,088 | 110,953 | 275,422 | 518,760 | 1,164,891 |
| Liability in respect of prior accident years at 100% level | | | | | | 26,576 |
| Total net liability at 100% level | | | | | | 1,191,467 |

Reconciliation of amounts disclosed at 100% level to liability disclosed in the Group's balance sheet

| Accident year | 2001 £000 | 2002 £000 | 2003 £000 | 2004 £000 | 2005 £000 | Total £000 |
|---|---|---|---|---|---|---|
| Current estimate of cumulative claims | 472,594 | 267,929 | 323,048 | 570,186 | 645,835 | 2,279,592 |
| Attributable to external names | (141,884) | (67,615) | (88,449) | (163,364) | (164,110) | (625,422) |
| Group share of current estimate of cumulative claims | 330,710 | 200,314 | 234,599 | 406,822 | 481,725 | 1,654,170 |
| Cumulative payments to date | (312,926) | (167,841) | (212,095) | (294,764) | (127,075) | (1,114,701) |
| Attributable to external names | 89,168 | 37,092 | 55,841 | 87,187 | 31,202 | 300,490 |
| Group share of cumulative payments | (223,758) | (130,749) | (156,254) | (207,577) | (95,873) | (814,211) |
| Liability for 2001 to 2005 accident years recognised on Group's balance sheet | 106,952 | 69,565 | 78,345 | 199,245 | 385,852 | 839,959 |
| Liability for accident years before 2001 recognised on Group's balance sheet | – | – | – | – | – | 14,734 |
| Total Group liability – net** | | | | | | 854,693 |

*The foreign exchange adjustment arises from the retranslation of the estimates at each date using the exchange rate ruling at 31 December 2005.

**This represents the claims element of the Group's insurance liabilities and reinsurance assets.

### 25.2 Movements in insurance claims liabilities and reinsurance claims assets

| Year ended 31 December | 2005 Gross £000 | 2005 Reinsurance £000 | 2005 Net £000 | 2004 Gross £000 | 2004 Reinsurance £000 | 2004 Net £000 |
|---|---|---|---|---|---|---|
| Total at beginning of year | (830,681) | 195,730 | (634,951) | (656,820) | 189,183 | (467,637) |
| Claims and claims handling expense for year | (810,678) | 353,653 | (457,025) | (447,753) | 65,690 | (382,063) |
| Cash paid for claims settled in the year | 391,710 | (109,904) | 281,806 | 240,200 | (49,630) | 190,570 |
| Exchange differences and other movements | (72,844) | 28,321 | (44,523) | 33,692 | (9,513) | 24,179 |
| Total at end of year | (1,322,493) | 467,800 | (854,693) | (830,681) | 195,730 | (634,951) |
| Notified claims | (815,307) | 281,746 | (533,561) | (478,050) | 125,186 | (352,864) |
| Incurred but not reported | (507,186) | 186,054 | (321,132) | (352,631) | 70,544 | (282,087) |
| Total at end of year | (1,322,493) | 467,800 | (854,693) | (830,681) | 195,730 | (634,951) |

The insurance claims expense reported in the income statement is comprised as follows:

| | 2005 Gross £000 | 2005 Reinsurance £000 | 2005 Net £000 | 2004 Gross £000 | 2004 Reinsurance £000 | 2004 Net £000 |
|---|---|---|---|---|---|---|
| Current year claims and loss adjustment expenses | (785,128) | 322,278 | (462,850) | (436,160) | 63,610 | (372,550) |
| (Under)/over provision in respect of prior year claims and loss adjustment expenses | (25,550) | 31,375 | 5,825 | (11,593) | 2,080 | (9,513) |
| Total claims and claims handling expense | (810,678) | 353,653 | (457,025) | (447,753) | 65,690 | (382,063) |

## 26 Trade and other payables and deferred income

### (a) Group

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Creditors arising out of direct insurance operations | 30,945 | 28,399 |
| Creditors arising out of reinsurance operations | 150,947 | 60,368 |
| | 181,892 | 88,767 |
| Obligations under finance leases (note 34) | 449 | 370 |
| Share of syndicate's other creditors balances | 34,331 | 16,641 |
| Reinsurers' share of deferred acquisition costs | 2,496 | 4,552 |
| Social security and other taxes payable | 6,191 | 5,458 |
| Other creditors | 12,255 | 3,040 |
| | 55,722 | 30,061 |
| Accruals and deferred income | 33,562 | 26,702 |
| Total | 271,176 | 145,530 |

| The amounts expected to be settled before and after one year are estimated as follows: | | |
|---|---|---|
| Within one year | 269,246 | 143,550 |
| After one year | 1,930 | 1,980 |
| | 271,176 | 145,530 |

The amounts expected to be settled after one year of the balance sheet date primarily relate to finance leases and the Group's provision of sabbatical leave employee benefits.

### (b) Company

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Due to Group companies | 49,975 | 41,419 |
| Other creditors | 223 | 61 |
| Total | 50,198 | 41,480 |

The liabilities of the Company all fall due for payment within one year of the balance sheet date.

## 27 Taxation

The amounts charged in the income statement comprise the following:

| | Group 2005 £000 | Group 2004 £000 |
|---|---|---|
| Current tax expense | 22,564 | 12,702 |
| Deferred tax expense (note 28) | (973) | 12,872 |
| | 21,591 | 25,574 |

The tax expense on the Group's profit before tax differs from the theoretical amount that would arise using the weighted average tax rate applicable to profits of the consolidated companies as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Profit before tax | 70,221 | 89,522 |
| Tax calculated at the standard UK Corporation tax rate of 30% (2004: 30%) | 21,067 | 26,857 |
| Effects of: | | |
| Expenses not deductible for tax purposes | 687 | 3,822 |
| Income not subject to tax | (113) | (3,221) |
| Foreign tax, income tax and excess tax on controlled foreign companies | (2,535) | (536) |
| Tax losses for which no deferred tax asset is recognised | 1,011 | 112 |
| Other items | (347) | (1,339) |
| Prior year current tax | 1,632 | 1,615 |
| Prior year deferred tax | 189 | (1,736) |
| Tax charge for the period | 21,591 | 25,574 |

## 28 Deferred tax

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Deferred tax assets | 16,366 | 15,618 | 5,025 | – |
| Deferred tax liabilities | (31,559) | (30,135) | (2,936) | (2,018) |
| Total net deferred tax asset/(liability) | (15,193) | (14,517) | 2,089 | (2,018) |

All material tax assets and liabilities relate to the same tax authority.

The movement on the total net deferred tax asset/(liability) is as follows:

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| At 1 January | (14,517) | (1,645) | (2,018) | – |
| Income statement (charge)/credit: | 973 | (12,872) | 4,107 | (2,018) |
| Transfer from deferred tax to current tax | (3,599) | – | – | – |
| Released from reserves | 1,950 | – | – | – |
| At 31 December | (15,193) | (14,517) | 2,089 | (2,018) |

(a) Group and Company deferred tax assets analysed by balance sheet headings

| At 31 December | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Tangible assets | 879 | 895 | 49 | – |
| Financial assets | 3,967 | 43 | 4,976 | – |
| Trade and other payables | 3,192 | 2,889 | – | – |
| Retirement benefit obligations | 5,004 | 10,416 | – | – |
| Other items | 3,324 | 1,375 | – | – |
| Total deferred tax assets | 16,366 | 15,618 | 5,025 | – |

(b) Group and Company deferred tax liabilities analysed by balance sheet headings and syndicate participation

| At 31 December | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Intangible assets | (377) | (36) | – | – |
| Investment in associated enterprises | (191) | (191) | – | – |
| Financial assets | – | (1,536) | (2,936) | (2,018) |
| Insurance contracts – equalisation provision* | (5,637) | (5,383) | – | – |
| Other items | (1,826) | (1,314) | – | – |
| | (8,031) | (8,460) | (2,936) | (2,018) |
| Open years of account and Section 107 disclaimers | (23,528) | (21,675) | – | – |
| Total deferred tax liabilities | (31,559) | (30,135) | (2,936) | (2,018) |

*The solvency regulations in the UK require certain entities within the Group to establish an equalisation provision, to be utilised against abnormal levels of future losses in certain lines of business. The regulations prescribe that the reserve is increased every year by an amount that is calculated as a percentage of net premiums written for those lines of business during the financial year subject to a maximum percentage. The amount of each annual increase is a deductible expense for tax purposes, and the equalisation reserve is taxed when released. The entities within the Group that are affected by this requirement continue to prepare their individual financial statements, for statutory filing and taxation purposes, in accordance with UK GAAP which permits the recognition of equalisation reserves on the balance sheet. Equalisation reserves are not permitted under IFRSs which therefore results in the temporary difference for taxation purposes.

Deferred income tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through the future taxable profits is probable. The Group has not provided for deferred tax assets totalling £2,671,000 in relation to losses of overseas companies (2004: £1,661,000). The aggregate amount of temporary differences associated with investments in subsidiaries and associates for which no deferred tax liability has been recognised is £16,892,000 (2004: £8,275,000). These temporary differences are unlikely to reverse in the foreseeable future. In accordance with IAS 12, all deferred tax assets and liabilities are classified as non current.

The Company had no unprovided deferred tax assets at the year end (2004: £nil).

## 29 Retirement benefit obligations

The gross amount recognised in the Group and Company balance sheets are determined as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Present value of funded obligations | 137,533 | 99,229 |
| Fair value of plan assets | (101,409) | (65,020) |
| Present value of unfunded obligations | 36,124 | 34,209 |
| Unrecognised actuarial gains/(losses) | (19,447) | 509 |
| Unrecognised past service cost | – | – |
| Gross liability in the balance sheet | 16,677 | 34,718 |

Included within loans and receivables for the Group (note 20) is a right to reimbursement of £5,462,000 (2004: £7,345,000) recoverable from third-party names in Syndicate 33 representing their contribution to funding the defined benefit scheme obligation.

The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. A full actuarial valuation is performed on a triennial basis and updated at each intervening balance sheet date by the actuaries. The last full actuarial valuation was performed at 31 December 2005. The present value of the defined benefit obligation is determined by discounting the estimated future cash flows using interest rates of AA rated corporate bonds that have terms to maturity that approximate the terms of the related pension liability.

The plan assets are invested as follows:

| At 31 December | 2005 £000 | 2004 £000 |
|---|---|---|
| Equities and property | 81,577 | 58,497 |
| Debt and fixed income securities | 4,993 | 4,750 |
| Cash | 14,839 | 1,773 |
| | 101,409 | 65,020 |

The amounts recognised in the Group's income statement are as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Current service cost | 2,916 | 2,997 |
| Interest cost | 5,228 | 4,921 |
| Expected return on plan assets | (4,767) | (3,461) |
| Net actuarial (gains)/losses recognised during the year | – | – |
| Past service cost | 670 | – |
| Total included in staff costs (note 11) | 4,047 | 4,457 |

The actual return on plan assets was £15,531,000 (2004: £4,777,000).

The movement in liability recognised in the Group and Company balance sheets are as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| At beginning of year | 34,718 | 33,334 |
| Total expense charged in the income statement of the Group (note 11) | 4,047 | 4,457 |
| Contributions paid | (22,088) | (3,073) |
| At end of year | 16,677 | 34,718 |

The Company recharges all pension related expenses to the individual operating subsidiaries that benefit from the services of the Group's employees.

The Group's actuaries have based their assessment on the most recent mortality data available which suggests that the average pensionable period in which benefits will be paid to members is 26 years (2004: 22 years). The other principal actuarial assumptions used in determining the defined benefit scheme's obligation were as follows:

| | 2005 % | 2004 % |
|---|---|---|
| Discount rate | 4.75 | 5.40 |
| Expected return on plan assets | 5.79 | 5.85 |
| Future salary increases | 4.00 | 3.80 |
| Inflation assumption | 3.00 | 2.80 |
| Pension increases | 3.00 | 2.80 |

During the year the Group contributed to the defined benefit scheme at the rate of 22.6% (2004: 22.6%) of pensionable salaries. Additional contributions totalling £19,400,000 were paid during 2005 to reduce the deficit. The Group has agreed that further additional contributions will be made. 61% of the deficit calculated is recharged to Syndicate 33.

## 30 Earnings per share

### Basic

Basic earnings per share is calculated by dividing the profit attributable to equity holders of the Company by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares purchased by the Group and held as own shares (note 23).

| | 2005 | 2004 |
|---|---|---|
| Profit attributable to the Company's equity holders (£000) | 48,630 | 63,948 |
| Weighted average number of ordinary shares (thousands) | 310,797 | 300,653 |
| Basic earnings per share (pence per share) | 15.6p | 21.3p |

The comparative weighted average number of shares in issue for 2004 has been adjusted for the effects of the Rights Issue in November 2005, in accordance with IAS 33 *Earnings per share.*

### Diluted

Diluted earnings per share is calculated adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares. The Company has one category of dilutive potential ordinary shares, share options. For the share options, a calculation is made to determine the number of shares that could have been acquired at fair value (determined as the average annual market share price of the Company's shares) based on the monetary value of the subscription rights attached to outstanding share options. The number of shares calculated as above is compared with the number of shares that would have been issued assuming the exercise of the share options.

| | 2005 | 2004 |
|---|---|---|
| Profit attributable to the Company's equity holders (£000) | 48,630 | 63,948 |
| Weighted average number of ordinary shares in issue (thousands) | 310,797 | 300,653 |
| Adjustments for share options (thousands) | 12,283 | 3,375 |
| Weighted average number of ordinary shares for diluted earnings per share (thousands) | 323,080 | 304,028 |
| Diluted earnings per share (pence per share) | 15.1p | 21.0p |

Diluted earnings per share has been calculated after taking account of 11,829,000 (2004: 2,435,000) options under employee share schemes and 454,000 (2004: 940,000) options under SAYE schemes.

## 31 Directors' emoluments and share option schemes

Information regarding the remuneration and emoluments of Directors is given in the Directors' remuneration report on pages 41 to 43.

### Share options

The conditions of exercise of the Approved and Unapproved share options is described on page 42.

| | Number of options at 1 January 2005 | Number of options granted | Number of options lapsed | Number of options exercised | Number of options at 31 December 2005 | Exercise price £ | Market price at date of exercise £ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|---|---|
| SJ Bridges | 82,092 | – | – | – | 82,092 | 1.320 | – | 13 Oct 02 | 12 Oct 09 |
| | 109,457 | – | – | – | 109,457 | 1.051 | – | 15 Jun 03 | 14 Jun 10 |
| | 54,728 | – | – | – | 54,728 | 1.809 | – | 03 May 04 | 02 May 11 |
| | 136,821 | – | – | – | 136,821 | 0.831 | – | 27 Sep 04 | 26 Sep 11 |
| | 175,000 | – | – | – | 175,000 | 1.290 | – | 19 Nov 05 | 18 Nov 12 |
| | 150,000 | – | – | – | 150,000 | 1.510 | – | 02 Apr 06 | 01 Apr 13 |
| | 150,000 | – | – | – | 150,000 | 1.560 | – | 13 Jul 07 | 12 Jul 14 |
| | – | 150,000 | – | – | 150,000 | 1.545 | – | 06 Apr 08 | 05 Apr 15 |
| | 858,098 | 150,000 | – | – | 1,008,098 | | | | |
| RS Childs | 87,566 | – | – | – | 87,566 | 1.622 | – | 20 Oct 01 | 19 Oct 08 |
| | 109,457 | – | – | – | 109,457 | 1.320 | – | 13 Oct 02 | 12 Oct 09 |
| | 164,186 | – | – | – | 164,186 | 1.051 | – | 15 Jun 03 | 14 Jun 10 |
| | 76,620 | – | – | – | 76,620 | 1.809 | – | 03 May 04 | 02 May 11 |
| | 136,821 | – | – | – | 136,821 | 0.831 | – | 27 Sep 04 | 26 Sep 11 |
| | 200,000 | – | – | – | 200,000 | 1.290 | – | 19 Nov 05 | 18 Nov 12 |
| | 200,000 | – | – | – | 200,000 | 1.510 | – | 02 Apr 06 | 01 Apr 13 |
| | 200,000 | – | – | – | 200,000 | 1.560 | – | 13 Jul 07 | 12 Jul 14 |
| | – | 200,000 | – | – | 200,000 | 1.545 | – | 06 Apr 08 | 05 Apr 15 |
| | 1,174,650 | 200,000 | – | – | 1,374,650 | | | | |
| RRS Hiscox | 87,565 | – | – | – | 87,565 | 1.622 | – | 20 Oct 01 | 19 Oct 08 |
| | 54,727 | – | – | – | 54,727 | 1.051 | – | 15 Jun 03 | 14 Jun 10 |
| | 54,728 | – | – | – | 54,725 | 1.809 | – | 03 May 04 | 02 May 11 |
| | 50,000 | – | – | – | 50,000 | 1.510 | – | 02 Apr 06 | 01 Apr 13 |
| | 50,000 | – | – | – | 50,000 | 1.560 | – | 13 Jul 07 | 12 Jul 14 |
| | – | 50,000 | – | – | 50,000 | 1.545 | – | 06 Apr 08 | 05 Apr 15 |
| | 297,020 | 50,000 | – | – | 347,020 | | | | |
| BE Masojada | 87,565 | – | – | – | 87,565 | 1.622 | – | 20 Oct 01 | 19 Oct 08 |
| | 109,457 | – | – | – | 109,457 | 1.320 | – | 13 Oct 02 | 12 Oct 09 |
| | 164,185 | – | – | – | 164,185 | 1.051 | – | 15 Jun 03 | 14 Jun 10 |
| | 76,620 | – | – | – | 76,620 | 1.809 | – | 03 May 04 | 02 May 11 |
| | 136,821 | – | – | – | 136,821 | 0.831 | – | 27 Sep 04 | 26 Sep 11 |
| | 200,000 | – | – | – | 200,000 | 1.290 | – | 19 Nov 05 | 18 Nov 12 |
| | 200,000 | – | – | – | 200,000 | 1.510 | – | 02 Apr 06 | 01 Apr 13 |
| | 200,000 | – | – | – | 200,000 | 1.560 | – | 13 Jul 07 | 12 Jul 14 |
| | – | 200,000 | – | – | 200,000 | 1.545 | – | 06 Apr 08 | 05 Apr 15 |
| | 1,174,648 | 200,000 | – | – | 1,374,648 | | | | |
| Other employees | 189,897 | – | – | (38,855) | 151,042 | 1.754 | 1.935-1.99 | 17 Dec 00 | 16 Dec 07 |
| | 635,377 | – | – | (162,663) | 472,714 | 1.622 | 1.66-2.23 | 20 Oct 01 | 19 Oct 08 |
| | 613,488 | – | – | (117,663) | 495,825 | 1.320 | 1.87-2.23 | 13 Oct 02 | 12 Oct 09 |
| | 1,131,538 | – | (8,209) | (182,568) | 940,761 | 1.051 | 1.57-2.23 | 15 Jun 03 | 14 Jun 10 |
| | 114,929 | – | – | – | 114,929 | 1.032 | – | 09 Nov 03 | 08 Nov 10 |
| | 109,456 | – | – | – | 109,456 | 1.736 | – | 14 Feb 04 | 13 Feb 11 |
| | 836,214 | – | (87,562) | (87,563) | 661,089 | 1.809 | 1.935-2.23 | 03 May 04 | 02 May 11 |
| | 1,373,672 | – | – | (246,275) | 1,127,397 | 0.831 | 1.545-2.23 | 27 Sep 04 | 26 Sep 11 |
| | 2,177,500 | – | (15,000) | (140,000) | 2,022,500 | 1.290 | 1.935-2.23 | 19 Nov 05 | 18 Nov 12 |
| | 2,317,500 | – | (15,000) | (150,000) | 2,152,500 | 1.510 | 1.66 | 02 Apr 06 | 01 Apr 13 |
| | 2,270,000 | – | (30,000) | – | 2,240,000 | 1.560 | – | 13 Jul 07 | 12 Jul 14 |
| | – | 2,395,000 | (10,000) | – | 2,385,000 | 1.545 | – | 06 Apr 08 | 05 Apr 15 |
| | 11,769,571 | 2,395,000 | (165,771) | (1,125,587) | 12,873,213 | | | | |
| Total | 15,273,987 | 2,995,000 | (165,771) | (1,125,587) | 16,977,629 | | | | |

31 Directors' emoluments and share option schemes continued

The interests of the Directors and employees under the UK and International Sharesave Schemes of the Group are set out below:

| | Number of options at 1 January 2005 | Number of options granted | Number of options lapsed | Number of options exercised | Number of options at 31 December 2005 | Exercise price* £/€ | Market price at date of exercise* £/€ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|---|---|
| UK Sharesave Scheme | | | | | | | | | |
| SJ Bridges | 7,321 | – | – | – | 7,321 | 1.26 | – | 01 Dec 06 | 31 May 07 |
| RS Childs | 7,321 | – | – | – | 7,321 | 1.26 | – | 01 Dec 06 | 31 May 07 |
| RRS Hiscox | 9,282 | – | – | – | 9,282 | 1.02 | – | 01 Dec 05 | 31 May 06 |
| RRS Hiscox | – | 5,757 | – | – | 5,757 | 1.62 | – | 01 Dec 08 | 31 May 09 |
| BE Masojada | 6,956 | – | – | – | 6,956 | 1.36 | – | 01 Dec 07 | 31 May 08 |
| Other employees | 118,749 | – | – | (118,749) | – | 0.67 | 1.585-1.91 | 01 Dec 04 | 31 May 05 |
| | 158,523 | – | (17,398) | (4,878) | 136,247 | 1.02 | 1.665-2.235 | 01 Dec 05 | 31 May 06 |
| | 326,200 | – | (43,656) | (1,439) | 281,105 | 1.26 | 1.665 | 01 Dec 06 | 31 May 07 |
| | 628,385 | – | (39,925) | – | 588,460 | 1.36 | – | 01 Dec 07 | 31 May 08 |
| | – | 382,213 | (5,756) | – | 376,457 | 1.62 | – | 01 Dec 08 | 31 May 09 |
| | 1,262,737 | 387,970 | (106,735) | (125,066) | 1,418,906 | | | | |
| International Sharesave Scheme | | | | | | | | | |
| Other employees | 83,913 | – | – | (83,913) | – | 1.06 | 2.30-2.35 | 03 Jan 05 | 02 Jul 05 |
| | 30,690 | – | – | – | 30,690 | 1.62 | – | 01 Dec 05 | 31 May 06 |
| | 19,286 | – | – | – | 19,286 | 1.81 | – | 01 Dec 06 | 31 May 07 |
| | 41,020 | – | – | – | 41,020 | 2.00 | – | 01 Dec 07 | 31 May 08 |
| | – | 42,013 | – | – | 42,013 | 2.39 | – | 01 Dec 08 | 31 May 09 |
| | 174,909 | 42,013 | – | (83,913) | 133,009 | | | | |

*International Sharesave Scheme prices are denominated in Euros.

The aggregate gains made by the Directors on exercise of the above options (based on market price at date of exercise less the exercise price) was £nil (2004: £20,000). The market price of Hiscox plc shares at 31 December 2005 was 231p (2004: 166.5p). The highest and lowest prices of Hiscox shares during 2005 were 234.5p and 152.25p (2004: 180.5p and 143.5p).

In January 2006 approval was received from HM Revenue & Customs to adjust the entitlement of participants in the Employee Share Schemes in respect of both the number of shares under option and the option exercise price to take account of the Rights Issue. The adjustments have been calculated in accordance with a formula set out by HM Revenue & Customs and have the effect that the number of options that each option holder is entitled to has increased by 3% and the price of each option has decreased by 3%. The aggregate monetary value of options granted has not changed as a result of the adjustment. These adjustments have taken place subsequent to the balance sheet date and are not reflected in the above tables.

(iii) Performance share plan

| | Number of options at 1 January 2005 | Number of options granted | Number of options lapsed | Number of options exercised | Number of options at 31 December 2005 | Exercise price £ | Market price at date of exercise £ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|---|---|
| SJ Bridges | 10,945 | – | – | (10,945) | – | 1.069 | 1.585 | 01 Apr 05 | 31 Dec 11 |
| RS Childs | 27,364 | – | – | (27,364) | – | 1.069 | 1.585 | 01 Apr 04 | 31 Dec 10 |
| RS Childs | 10,945 | – | – | (10,945) | – | 1.069 | 1.585 | 01 Apr 05 | 31 Dec 11 |
| RRS Hiscox | 10,945 | – | – | (10,945) | – | 1.069 | 1.5925 | 01 Apr 05 | 31 Dec 11 |
| BE Masojada | 10,945 | – | – | (10,945) | – | 1.069 | 1.585 | 01 Apr 05 | 31 Dec 11 |
| Other employees | 27,364 | – | (27,364) | – | – | 1.069 | – | 01 Apr 04 | 31 Dec 10 |
| | 172,927 | – | (10,945) | (158,699) | 3,283 | 1.069 | 1.5675-1.69 | 01 Apr 05 | 31 Dec 11 |
| Total | 271,435 | – | (38,309) | (229,843) | 3,283 | | | | |

32 Dividends

| | Group 2005 £000 | Group 2004 £000 | Company 2005 £000 | Company 2004 £000 |
|---|---|---|---|---|
| Interim dividend for the year ended: | | | | |
| 31 December 2004 of 1.5p (net) per share | – | 4,383 | – | 4,383 |
| 31 December 2005 of 2.25p (net) per share | 6,631 | – | 6,631 | – |
| Final dividend for the year ended: | | | | |
| 31 December 2003 of 2.9p (net) per share | – | 8,450 | – | 8,457 |
| 31 December 2004 of 3.5p (net) per share | 10,286 | – | 10,286 | – |
| | 16,917 | 12,833 | 16,917 | 12,840 |

A final dividend in respect of 2005 of 4.75p per share, amounting to a total dividend of 7p for the year, is to be proposed at the Annual General Meeting on 20 June 2006. These financial statements do not reflect this final dividend as a distribution or liability in accordance with IAS 10 *Events after the Balance Sheet Date*.

## 33 Contingencies and guarantees

The Company and its subsidiaries are, like all other insurers, continuously involved in legal proceedings, claims and litigation in the normal course of business. The Group does not believe that such actions will have a material effect on its profit or loss and financial condition.

The Group is subject to insurance solvency regulations in all the territories in which it issues insurance contracts, and it has complied with all the local solvency regulations. There are no contingencies associated with the Group's compliance or lack of compliance with these regulations.

The following guarantees have also been issued:

(a) The Company has entered into a deed of covenant in respect of its corporate member subsidiaries, Hiscox Dedicated Corporate Member Limited, Hiscox Select A to J Limited, to meet the subsidiaries' obligations to Lloyd's. The total guarantee given by the Company under this deed of covenant (subject to limited exceptions) amounts to £118,831,798 (2004: £117,209,120). The obligations in respect of this deed of covenant are secured by a fixed and floating charge over certain of the investments and other assets of the Company in favour of Lloyd's. Lloyd's has a right to retain the income on the charged investments in circumstances where it considers there to be a risk that the covenant might need to be called and may be met in full

(b) The Company has an agreement with Lloyds TSB Bank, an agent for a syndicate of banks, for a £137,500,000 irrevocable standby Letter of Credit Facility and a US $225,000,000 Term and Revolving Credit Facility. Commencing 7 November 2005 £137,500,000 was drawn down on the Letter of Credit Facility to support part of the Group's underwriting activities. Hiscox plc has given a fixed and floating charge over the Group's assets as a guarantee to the group of banks led by Lloyds TSB Bank in connection with their Letter of Credit. On 5 December 2005, the Group drew down US $208,000,000 of the term and revolving credit facility to support its investment in the new Bermudan operations

(c) Hiscox Insurance Company Limited has arranged a Letter of Credit of £325,000 with Natwest Bank plc to support its consortium activities with Lloyd's

(d) The managed syndicate is subject to the New Central Fund annual contribution, which is an annual fee calculated on capacity. This fee was 0.5% for 2005, and is 1.0% for 2006 with a further 0.75% being loaned to the New Central Fund. In addition to this fee, the Council of Lloyd's has the discretion to call a further contribution of up to 3% of capacity if required.

## 34 Capital and lease commitments

### Capital commitments

The Group's capital expenditure contracted for at the balance sheet date but not yet incurred is as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Property, plant and equipment | 1,150 | – |
| Intangible assets | – | – |
| | 1,150 | – |

The Company had no capital commitments at 31 December 2005 or 2004.

### Operating lease commitments

The Group acts as both lessee and lessor in relation to various offices in the UK and overseas which are held under non–cancellable operating lease agreements. The leases have varying terms, escalation clauses and renewal rights. The Group also has payment obligations in respect of operating leases for certain items of office equipment. Operating lease rental expenses, net of recharges to the managed syndicate, for the year totalled £1,936,000 (2004: £2,041,000). Operating lease rental income for the year totalled £586,000 (2004: £241,000).

The aggregate minimum lease payments required by the Group under non-cancellable operating leases, over the expected lease terms, are as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| No later than one year | | |
| Land and buildings | 4,326 | 4,113 |
| Office equipment | 57 | 180 |
| Later than one year and no later than five years | | |
| Land and buildings | 14,679 | 14,221 |
| Office equipment | 31 | 120 |
| Later than five years | | |
| Land and buildings | 26,126 | 29,527 |
| Office equipment | – | – |
| | 45,219 | 48,161 |

## 34 Capital and lease commitments continued

The total future aggregate minimum lease rentals receivable by the Group and the Company as lessor under non-cancellable operating property lease are as follows:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| No later than one year | 586 | 586 |
| Later than one year and no later than five years | 2,205 | 2,312 |
| Later than five years | 1,027 | 1,507 |
| | 3,818 | 4,405 |

### Obligations under finance leases

It is the Group's policy to lease certain of its motor vehicles under finance lease arrangements. The leases have a typical term of three years and are on a fixed repayment basis with a final lump sum component at the end of each agreement should the Group decide to acquire ownership of the vehicle. Interest rates are fixed at the contract commencement date. The Group's obligations under leases are secured by the lessors' charges over the leased assets.

Finance lease interest expenses, net of recharges to the managed syndicate, for the year totalled £32,000 (2004: £25,000).

The finance lease obligations to which the Group are committed include the following minimum lease payments:

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Current liabilities due for settlement within one year | 222 | 171 |
| Non-current liabilities due for settlement after one year and no later than five years | 293 | 258 |
| | 515 | 429 |
| Less: future finance lease interest charges | (66) | (59) |
| | 449 | 370 |

The present value of the minimum lease payments is not materially different to the currently disclosed obligation.

The Company has no finance lease obligations or capital commitments.

## 35 Principal subsidiary companies

As at 31 December 2005

| Company | Nature of business | Country |
|---|---|---|
| Hiscox Insurance Company Limited* | General insurance | Great Britain |
| Hiscox Insurance Company (Guernsey) Limited* | General insurance | Guernsey |
| Hiscox Inc.* | Underwriting agent | USA (Delaware) |
| Hiscox Holdings Inc.* | Insurance holding company | USA (Delaware) |
| Hiscox Insurance Company (Bermuda) Limited | General insurance and reinsurance | Bermuda |
| Hiscox Dedicated Corporate Member Limited | Lloyd's corporate names | Great Britain |
| Hiscox Select Insurance Fund PLC | Insurance holding company | Great Britain |
| Hiscox Select Holdings Limited* | Insurance holding company | Great Britain |
| Hiscox Select A to J Limited* | Lloyd's corporate name | Great Britain |
| Hiscox Holdings Limited** | Insurance holding company | Great Britain |
| Hiscox Insurance Holdings Limited | Insurance holding company | Great Britain |
| Hiscox Assurances Services SARL* | Underwriting agent | France |
| Hiscox International Holdings B.V.* | Insurance holding company | Netherlands |
| Hiscox Syndicates Limited* | Lloyd's managing agent | Great Britain |
| Hiscox Underwriting Ltd* | Lloyd's managing agent | Great Britain |
| Hiscox AG* | Underwriting agent | Germany |
| Hiscox bv* | Underwriting agent | Netherlands |
| Hiscox Investment Management Limited | Investment management | Great Britain |
| Hiscox Connect Limited | Online intermediary | Great Britain |
| Hiscox Underwriting Group Services Limited | Service company | Great Britain |
| Hiscox NV* | Underwriting agent | Belgium |
| Hiscox Trustees Limited† | Corporate trustee | Great Britain |
| Hiscox Pension Trustees Limited | Pension trustee | Great Britain |
| Hiscox Qualifying Employees Share Ownership Trustees Limited | Share scheme trustee | Great Britain |

All companies are wholly owned. The proportion of voting rights of subsidiaries held is the same as the proportion of equity shares held.

*Held indirectly.

**Hiscox Holdings Limited held 54,560 (2004: 67,580 shares) in Hiscox plc at 31 December 2005. The cost of these shares of £52,000 (2004: £64,000) is included within retained earnings. During 2005, 13,020 of these shares were issued to staff as part of the employee performance share plans (2004: 339,304 shares). The net consideration received was £18,000 (2004: £363,000).

†Hiscox Trustees Limited is the trustee of the Hiscox plc Group Employee Share Ownership Plan (ESOP). Hiscox Trustees Limited took up its entitlement of 33,459 shares in the Company at a price of £1.83 arising from the Rights Issue in November 2005. It also acquired 6,732 ordinary shares costing £11,000 during the year. The ESOP disposed of 229,843 shares during the year at a price of £1.26. The ESOP owned 135,782 shares (2004: 325,434 shares) in Hiscox plc at 31 December 2005. The shares have been purchased by the ESOP for future use in employee share option schemes and are held as own shares. None of these shares are currently under option to employees, nor have any been conditionally gifted to them. The cost of these shares of £192,000 (2004: £409,000) is included within retained earnings.

## 36 Related-party transactions

Details of the remuneration of the Group's key personnel are shown in the Director's remuneration report on pages 41 to 43. A number of the Group's key personnel hold insurance contracts and investment management agreements with the Group, all of which are on normal commercial terms.

The following transactions were conducted with related parties during the year.

### (a) Syndicate 33 at Lloyd's

Hiscox Syndicates Limited, a wholly owned subsidiary of the Company, received management fees and profit commissions for providing a range of management services to Syndicate 33 in which Hiscox Dedicated Corporate Member Limited and the corporate member subsidiaries of Hiscox Select Insurance Fund PLC participated.

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Value of services provided by Hiscox Syndicates Limited to Syndicate 33 | 25,918 | 15,305 |
| Amounts receivable from Syndicate 33 at 31 December | 3,157 | 30 |

### (b) Associates

Certain companies within the Group received management and other commercial services from a number of wholly owned subsidiaries of Heritage Group Limited, which was an associate of the Group until 11 July 2005. These transactions arose in the normal course of business and are based on arms length arrangements. One Director of Heritage Group Limited is also a Director of Hiscox Insurance Company (Guernsey) Limited. The ultimate parent Company of Hiscox Insurance Company (Guernsey) Limited is Hiscox plc.

| | 2005 US$000 | 2004 US$000 |
|---|---|---|
| Value of management services provided during the year by the consolidated operations of the Heritage Group Limited | 855 | 701 |
| Amounts payable/(receivable) at 31 December | – | – |

The Group's debtors receivable at 31 December 2004 (note 20) included an amount due from Heritage Group Limited of £1,580,000 in respect of an original balance of £1,900,000 due to Hiscox Insurance Company Limited. Repayments of £1,580,000 (2004: £320,000) were received by the Group during the year. There were no amounts outstanding at 31 December 2005.

Certain companies within the Group conduct insurance and other business with Blyth Valley Limited, an associate. These transactions arise in the normal course of obtaining insurance business through brokerages, and are based on arms length arrangements. One Director of Blyth Valley Limited also served as a Director of Hiscox Insurance Company Limited. The ultimate parent Company of Hiscox Insurance Company Limited is Hiscox plc.

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Gross premium income achieved through Blyth Valley Limited during year | 1,808 | 1,146 |
| Commission expense for year charged by Blyth Valley Limited | 368 | 243 |
| Amounts payable to Blyth Valley Limited at 31 December in respect of commissions | 40 | 23 |
| Amounts receivable from Blyth Valley Limited at 31 December in respect of insurance premiums | 1 | 2 |

### (c) Other

BE Masojada is a Non Executive Director of Ins-sure Holdings Limited and its subsidiaries, appointed in October 2002. These companies operate in a joint venture between Lloyd's, the International Underwriting Association (IUA) and Xchanging. These companies provide policy issuance, premium collection, claims settlement and clearing services to Lloyd's and the London insurance company markets. Hiscox Underwriting Group Services Limited received the annual fee of £20,000 (2004: £20,000) in relation to this directorship. The balance due at 31 December 2005 was £10,000 (2004: £5,000).

BE Masojada is also Deputy Chairman of Lloyd's. Hiscox Underwriting Group Services Limited received the annual fee of £41,250 (2004: £41,250) in relation to his services. There were no amounts outstanding at 31 December 2005 (2004: £nil).

36 Related-party transactions continued

(d) Parent Company
The Company engaged in the following transactions with other Group companies during the year under review.

| | 2005 £000 | 2004 £000 |
|---|---|---|
| Dividends receivable from other Group companies: | | |
| Hiscox Dedicated Corporate Member Limited | – | 12,000 |
| Hiscox Holdings Limited | 18,000 | 2,500 |
| Hiscox Select Insurance Fund PLC | – | 5,000 |
| | 18,000 | 19,500 |
| Expenses recharged from other Group companies: | | |
| Hiscox Underwriting Group Services Limited | 6,755 | 4,262 |
| Other | 104 | 97 |
| | 6,859 | 4,359 |
| Amounts due (to)/from other Group companies at 31 December: | | |
| Hiscox Dedicated Corporate Member Limited | 14,634 | 47,553 |
| Hiscox Holdings Limited | 20,023 | 1,579 |
| Hiscox Select Insurance Fund PLC and subsidiaries | (23,387) | (13,830) |
| Hiscox Syndicates Limited | (14,520) | (5,968) |
| Hiscox Underwriting Group Services Limited | 50,677 | 45,403 |
| Hiscox Insurance Holdings Limited | 54,508 | 54,508 |
| Other | 6,310 | 4,899 |
| | 108,245 | 134,144 |

# Five year summary

| | 2005<br>£000 | 2004<br>£000 | 2003<br>£000 | 2002<br>£000 | 2001<br>£000 |
|---|---|---|---|---|---|
| **Results** | | | | | |
| Gross premium written | 861,174 | 816,609 | 797,380 | 676,705 | 548,926 |
| Net premium written | 681,236 | 704,085 | 660,966 | 416,144 | 412,577 |
| Net premium earned | 693,299 | 714,852 | 547,451 | 385,129 | 344,199 |
| Profit/(loss) on ordinary activities before tax | 70,221 | 89,522 | 83,408 | 20,739 | (32,496) |
| Profit/(loss) on ordinary activities after tax | 48,630 | 63,948 | 60,491 | 14,399 | (23,107) |
| **Assets employed** | | | | | |
| Intangible assets | 33,099 | 29,989 | 21,753 | 23,086 | 23,797 |
| Financial assets | 1,237,778 | 980,731 | 773,289 | 501,774 | 344,402 |
| Cash and cash equivalents | 413,759 | 119,563 | 52,945 | 121,196 | 62,520 |
| Net technical provisions | (1,216,624) | (1,008,032) | (845,450) | (613,108) | (512,993) |
| Other net assets | 110,001 | 246,575 | 327,300 | 246,184 | 247,065 |
| Net assets | 578,013 | 368,826 | 329,837 | 279,132 | 164,791 |
| Net asset value per share | 147.7p | 125.7p | 113.5p | 97.0p | 85.5p |
| **Key statistics** | | | | | |
| Earnings/(loss) per share based on profit/(loss) on ordinary activities after tax | 15.6p | 21.3p | 20.9p | 6.9p | (14.8)p |
| Diluted earnings/(loss) per share based on profit/(loss) on ordinary activities after tax | 15.1p | 21.0p | 20.6p | 6.7p | (14.8)p |
| Combined ratio | 96.0% | 92.6% | 87.2% | 94.8% | 109.9% |
| Return on equity | 12.8% | 20.6% | 21.7% | 8.7% | (17.3)% |
| Dividends per share | 7.00p | 5.00p | 4.20p | 3.54p | 0.00p |
| Share price – high* | 234.5p | 180.5p | 170.5p | 164.5p | 226.0p |
| Share price – low* | 152.25p | 143.5p | 137.0p | 120.5p | 72.5p |

*Closing mid market prices.

The amounts and ratios for 2001 to 2003 are those previously published on a UK GAAP basis, the Group's primary reporting framework at that time. The figures reported for 2004 and 2005 are prepared in accordance with IFRSs as adopted by the EU. The main differences arising on the Group's transition to IFRSs are outlined at note 3 to the financial statements.

# Notice of Annual General Meeting

Notice is hereby given that the Annual General Meeting of Hiscox plc will be held at 1 Great St Helen's, London EC3A 6HX on 20 June 2006 at 11:00 am for the following purposes:

## Ordinary business

(1) To receive the accounts of the Company for the year ended 31 December 2005 together with the Directors' and auditors' reports thereon.

(2) To re-appoint RRS Hiscox who retires as a Director in accordance with the Articles of Association and the Combined Code.

(3) To re-appoint AGC Howland Jackson who retires as a Director in accordance with the Articles of Association and the Combined Code.

(4) To re-appoint DND Netherton who retires as a Director in accordance with the Articles of Association and the Combined Code.

(5) To appoint AR Auer who has been appointed as a Director since the previous Annual General Meeting, in accordance with the Articles of Association and the Combined Code.

(6) To appoint Sir Mervyn Pedelty who has been appointed as a Director since the previous Annual General Meeting, in accordance with the Articles of Association and the Combined Code.

(7) To re-appoint KPMG Audit Plc as auditors of the Company to hold office from the conclusion of this meeting until the conclusion of the next general meeting of the Company at which accounts are laid.

(8) To authorise the Directors to determine the level of auditors' remuneration.

(9) To consider the recommendation of the Directors as to a final dividend for the year ended 31 December 2005 of 4.75 pence (net) per ordinary share payable to shareholders on the register at the close of business on 21 April 2006.

## Special business

To consider and, if thought fit, pass the following resolutions, of which resolutions 10 and 11 will be proposed as ordinary resolutions, and resolutions 12 and 13 will be proposed as special resolutions.

## Ordinary resolutions

(10) To approve the Directors' remuneration report for the year ended 31 December 2005.

(11) That the Directors be generally and unconditionally authorised (in substitution for all existing authorities) pursuant to Section 80 of the Companies Act 1985 ("the Act") to allot relevant securities (within the meaning of that Section) up to a maximum aggregate nominal value of £6,533,231.86, representing 33.3% of the issued ordinary share capital as at 13 March 2006, for a period expiring (unless previously renewed, varied or revoked by the Company in general meeting) on the earlier of the conclusion of the next Annual General Meeting or the date falling 15 months from the date of the passing of this resolution, provided that the authority of the Directors shall extend to the making of any offer or agreement before the expiration or revocation of this authority which would or might require relevant securities to be allotted after the expiration or revocation of this authority and the Directors may allot relevant securities in pursuance of any such offer or agreement notwithstanding the expiry or revocation of this authority.

## Special resolutions

(12) That the Directors be empowered (in substitution for all existing authorities) pursuant to Section 95 of the Act to allot equity securities (as defined in Section 94(2) of the Act) for cash pursuant to the authority conferred by Resolution 11 as if Section 89(1) did not apply to the allotment. This power will expire on the earlier of the conclusion of the next Annual General Meeting or a date falling 15 months after the date of the passing of this resolution but the Company may before such expiry make an offer or agreement which would or might require equity securities to be allotted after the expiry of this power and the Directors may allot equity securities in pursuance of that offer or agreement as if the authority conferred by this resolution had not expired provided that this power is limited to:

(i) allotments of equity securities where such securities have been offered (whether by way of a Rights Issue, open offer or otherwise) to holders of ordinary shares in proportion (as nearly as may be) to their existing holdings of ordinary shares but subject to the Directors having a right to make such exclusions or other arrangements in connection with the offer as they deem necessary or expedient:

(a) to deal with equity securities representing fractional entitlements

(b) to deal with legal or practical problems under the laws of, or the requirements of any recognised regulatory body or any stock exchange in, any territory.

(ii) the allotment of ordinary shares for cash otherwise than pursuant to paragraph (i) up to an aggregate nominal amount of £979,984.78.

(13) That the Company be authorised to purchase its own shares from the market. The authority will be limited to a purchase of own shares up to a maximum number of 19,500,000 shares and the price to be paid for the shares will be limited to a minimum share price of £0.50 per share and a maximum price per share that is not more than five per cent above the average of the closing middle market quotations for an ordinary share as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the date on which the ordinary share is purchased. This authority will terminate on the earlier of the conclusion of the next Annual General Meeting or a date falling 15 months after the date of the passing of this resolution.
The Company may make a contract or contracts to purchase ordinary shares under the authority hereby conferred prior to the expiry of such authority which will or may be executed wholly or partly after the expiry of such authority and may make a purchase of ordinary shares in pursuance of any such contract or contracts.

By order of the Board

SJ Bridges
*Secretary*
13 March 2006

Notes

1. A member entitled to attend and vote at the Annual General Meeting (the 'Meeting') may appoint one or more proxies (who need not be a member of the Company) to attend and, on a poll, to vote on his or her behalf. In order to be effective, any appointment of proxy must be undertaken in accordance with these notes and returned:

   - in hard copy form by post, by courier or by hand, to the Company's registrars, Capita Registrars, Proxy Department, The Registry, 34 Beckenham Road, Beckenham, Kent BR3 4BR, not later than 48 hours before the time for holding the Meeting (or in the event that the Meeting is adjourned, 48 hours before the time of any adjourned Meeting)
   - in the case of CREST members (including Personal Members), by having an appropriate CREST message transmitted.

2. Return of the form of proxy will not preclude a member from attending the Meeting and voting in person.
3. To appoint a proxy or to give an instruction to a previously appointed proxy via the CREST system, the CREST message must be received by the issuer's agent (ID RA10) not later than 48 hours before the time for holding the Meeting or (as the case may be) the adjourned meeting. Please note, however, that proxy messages cannot be sent through CREST on weekends, bank holidays or after 8.00 pm on any day. For the purpose of this deadline, the time of receipt will be taken to be the time (as determined by the timestamp applied to the message by the CREST Applications Host) from which the issuer's agent is able to retrieve the message. CREST Personal Members or other CREST sponsored members and those CREST members that have accepted voting service provider(s) should contact their CREST sponsor or voting service provider(s) for assistance with appointing proxies via CREST. For further information on CREST procedures, limitations and system timings, please refer to the CREST manual. We may treat as invalid a proxy appointment sent by CREST in the circumstances set out in Regulation 35(5)(a) of the Uncertificated Securities Regulations 2001.
4. In accordance with Regulation 41 of the Uncertificated Securities Regulations 2001, only those members entered on the relevant register of members of the Company as at 6.00 pm on 18 June 2006 (or in the event that the Meeting is adjourned, 48 hours before the time of any adjourned Meeting) shall be entitled to attend or vote at the Meeting in respect of the number of shares registered in their name at that time. Changes to entries on the relevant register of members after 6.00 pm on 18 June 2006 (or in the event that the Meeting is adjourned, 48 hours before the time of any adjourned meeting) shall be disregarded in determining the rights of any person to attend or vote at the meeting.

Copies of the register of Directors' interests and copies of Directors' service contracts (including the terms and conditions of appointment of Non Executive Directors) kept by the Company will be available for inspection for at least 15 minutes before the commencement of the Meeting and will remain available during the continuance of the Meeting to any person attending the Meeting.

# Definition of insurance terms

Binder (or binding authority)
An authority granted by an underwriter to an agent (known as a coverholder) whereby that agent is entitled to accept, within certain limits, insurance business on behalf of the underwriter.

Cedant
An insurer that transfers insurance risk to another insurer under a reinsurance contract.

Claims ratio
Net claims incurred, including IBNR, as a percentage of net earned premiums.

Combined ratio
The total of the claims and expenses ratios.

Coverholder
An agent authorised to accept, within certain limits, insurance business on behalf of an underwriter. The coverholder deals with premium collection, the issue of certificates and in certain instances the servicing of claims, and has full power to commit the underwriter within the terms of the authority.

Expense ratio
Net operating expenses as percentage of net earned premiums.

Gross written premium
Premiums contracted for before any deductions.

Incurred loss ratio
Paid and outstanding losses as a percentage of premiums. Gross incurred loss ratio is before deducting any reinsurance; the net loss ratio is after deducting reinsurance.

Individual capital assessments
Risk-based calculations of the capital required by each FSA-authorised insurance entity in accordance with FSA regulations.

Long-tail
A term used to describe an insurance risk that has the potential for claims development or new claims to be reported a number of years after expiry of the term of the policy.

Member or Name
An underwriting member of Lloyd's. Groups of these individuals ('Names') collectively accept insurance risks through a Lloyd's syndicate. Names are required to meet certain Lloyd's solvency requirements and are responsible for their share of any losses made by the syndicates on which they participate, and are entitled to an equivalent share of any profits.

Net earned premium
Premiums received after the cost of reinsurance and adjustment for unearned premium. Unearned premium covers the future period of risk of an insurance policy.

Net written premium
Premiums received after the cost of reinsurance.

Open year
A year of account of a syndicate which has not been closed by reinsurance to close ('RITC'). RITC usually occurs at the end of the third year. A year of account can be left open beyond the third year if the extent of the future liability cannot be accurately quantified.

Qualifying quota share reinsurance
These are quota share reinsurance policies, which Lloyd's allow in certain circumstances, that enable a syndicate to write gross premium in excess of its authorised stamp capacity.

Quota shares
Where insurance risks are re-insured on a proportional basis, premiums and claims are divided in the same proportions between the insurer and re-insurer.

Return on equity ('ROE')
Net profit after tax expressed as a percentage of adjusted opening equity. This percentage measures profitability by expressing the efficiency of the Group's utilisation of shareholders' funds.

Reinsurance to Close ('RITC')
The reinsurance to close of a syndicate comprises a premium payable by the closing year to the members on the next open year of account and a contract which transfers the liability for all claims in respect of the closing year to the next open year.

Short-tail
A term used to describe an insurance risk where claims are expected to arise near to the dates on which a policy was current.

Specie
The line of business that covers cash and valuables in vaults, premises or transit.

Stamp capacity or syndicate capacity
The maximum amount of business that a syndicate in Lloyd's can write per year, aggregated from all its members.

Subrogation
The right of the underwriter to 'stand in the shoes of the insured' and take over the insured's rights, following payment of a claim, to recover the payment of an incurred loss from a third party responsible for the loss. It is limited to the amount of the loss paid by the insurance policy.

Syndicate
A grouping of Lloyd's underwriters. Each syndicate has an active underwriter who is authorised to accept business on behalf of each underwriting member participating therein. A member of a syndicate is still a principal in his own right and is personally liable for his agreed share of each risk that is accepted by the syndicate. He is not liable for the debts of other syndicate members and thus the liability is several but not joint.

Year of account
The year to which risk is allocated and to which all premiums and claims in respect of that risk are attributed. The year of account of a risk is determined by the calendar year in which it incepts. A year of account is normally closed by reinsurance at the end of 36 months.

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