

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

August 06, 2010

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended June 30, 2010.**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 001-13790  
HCC Insurance Holdings, Inc.**

(Exact name of registrant as specified in its charter)

Delaware

76-0336636

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

13403 Northwest Freeway, Houston, Texas

77040-6094

(Address of principal executive offices)

(Zip Code)

(713) 690-7300

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.

On July 31, 2010, there were approximately 115.2 million shares of common stock outstanding.

---

**HCC INSURANCE HOLDINGS, INC.  
TABLE OF CONTENTS**

|   | <b>Page</b> |
|---|-------------|
| <b>Part I. FINANCIAL INFORMATION</b>  |             |
| Item 1. Financial Statements  |             |
| <u>Condensed Consolidated Balance Sheets June 30, 2010 and December 31, 2009 (unaudited)</u>                              | 5           |
| <u>Condensed Consolidated Statements of Earnings Six months and three months ended June 30, 2010 and 2009 (unaudited)</u> | 6           |
| <u>Condensed Consolidated Statement of Changes in Shareholders Equity Six months ended June 30, 2010 (unaudited)</u>      | 7           |
| <u>Condensed Consolidated Statements of Cash Flows Six months ended June 30, 2010 and 2009 (unaudited)</u>                | 8           |
| <u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>   | 9           |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                      | 27          |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>   | 43          |
| <u>Item 4. Controls and Procedures</u>  | 43          |
| <b>Part II. OTHER INFORMATION</b>   |             |
| <u>Item 1. Legal Proceedings</u>  | 44          |
| <u>Item 1A. Risk Factors</u>  | 44          |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 44          |
| <u>Item 6. Exhibits</u>   | 44          |
| <u>Signatures</u>   | 46          |
| <u>EX-10.2</u>  |             |
| <u>EX-12</u>  |             |
| <u>EX-31.1</u>  |             |
| <u>EX-31.2</u>  |             |
| <u>EX-32</u>  |             |
| <u>EX-101 INSTANCE DOCUMENT</u>   |             |
| <u>EX-101 SCHEMA DOCUMENT</u>   |             |
| <u>EX-101 CALCULATION LINKBASE DOCUMENT</u>   |             |
| <u>EX-101 LABELS LINKBASE DOCUMENT</u>  |             |
| <u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>  |             |
| <u>EX-101 DEFINITION LINKBASE DOCUMENT</u>  |             |

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

*This Report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this Report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as growth of our business and operations, business strategy, competitive strengths, goals, plans, future capital expenditures and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, expect, intend, plan, probably or similar expressions, we are making forward-looking statements.*

*Many risks and uncertainties may have an impact on the matters addressed in these forward-looking statements, which could affect our future financial results and performance, including, among other things:*

*the effects of catastrophic losses,*

*the cyclical nature of the insurance business,*

*inherent uncertainties in the loss estimation process, which can adversely impact the adequacy of loss reserves,*

*the impact of the credit market downturn and subprime market exposures,*

*the effects of emerging claim and coverage issues,*

*the effects of extensive governmental regulation of the insurance industry,*

*potential credit risk with brokers,*

*the effects of industry consolidations,*

*our assessment of underwriting risk,*

*our retention of risk, which could expose us to potential losses,*

*the adequacy of reinsurance protection,*

*the ability and willingness of reinsurers to pay balances due us,*

*the occurrence of terrorist activities,*

*our ability to maintain our competitive position,*

*changes in our assigned financial strength ratings,*

*our ability to raise capital and funds for liquidity in the future,*

*attraction and retention of qualified employees,*

*fluctuations in securities markets, which may reduce the value of our investment assets, reduce investment income or generate realized investment losses,*

*our ability to successfully expand our business through the acquisition of insurance-related companies,  
impairment of goodwill,*

**Table of Contents**

*the ability of our insurance company subsidiaries to pay dividends in needed amounts,*

*fluctuations in foreign exchange rates,*

*failures or constraints of our information technology systems,*

*changes to the country's health care delivery system,*

*the effects, if any, of climate change, on the risks we insure,*

*change of control, and*

*difficulties with outsourcing relationships.*

*We describe these risks and uncertainties in greater detail in Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2009.*

*These events or factors could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions, and, therefore, also the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements that are included in this Report, our inclusion of this information is not a representation by us or any other person that our objectives or plans will be achieved.*

*Our forward-looking statements speak only at the date made, and we will not update these forward-looking statements unless the securities laws require us to do so. In light of these risks, uncertainties and assumptions, any forward-looking events discussed in this Report may not occur.*

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Condensed Consolidated Balance Sheets**  
**(unaudited, in thousands except per share data)**

|  | <b>June 30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|--|--------------------------|----------------------------------|
| <b>ASSETS</b>  |                          |                                  |
| Investments  |                          |                                  |
| Fixed income securities available for sale, at fair value (amortized cost: 2010 \$4,678,263; 2009 \$4,381,762) | \$ 4,903,206             | \$ 4,538,073                     |
| Fixed income securities held to maturity, at amortized cost (fair value: 2010 \$174,653; 2009 \$104,008)       | 172,349                  | 102,792                          |
| Short-term investments, at cost, which approximates fair value   | 476,176                  | 810,673                          |
| Other investments  | 433                      | 4,691                            |
| <b>Total investments</b>   | <b>5,552,164</b>         | <b>5,456,229</b>                 |
| Cash   | 84,162                   | 129,460                          |
| Restricted cash and cash investments   | 159,756                  | 146,133                          |
| Premium, claims and other receivables  | 695,670                  | 600,332                          |
| Reinsurance recoverables   | 1,054,659                | 1,016,411                        |
| Ceded unearned premium   | 271,783                  | 270,436                          |
| Ceded life and annuity benefits  | 59,480                   | 61,313                           |
| Deferred policy acquisition costs  | 216,988                  | 208,463                          |
| Goodwill   | 821,729                  | 822,006                          |
| Other assets   | 130,028                  | 123,608                          |
| <b>Total assets</b>  | <b>\$ 9,046,419</b>      | <b>\$ 8,834,391</b>              |

**LIABILITIES**

|  |                  |                  |
|--|------------------|------------------|
| Loss and loss adjustment expense payable | \$ 3,528,606     | \$ 3,492,309     |
| Life and annuity policy benefits         | 59,480           | 61,313           |
| Reinsurance balances payable             | 183,631          | 182,661          |
| Unearned premium                         | 1,069,355        | 1,044,747        |
| Deferred ceding commissions              | 68,657           | 71,595           |
| Premium and claims payable               | 166,675          | 154,596          |
| Notes payable                            | 298,560          | 298,483          |
| Accounts payable and accrued liabilities | 472,605          | 497,504          |
| <b>Total liabilities</b>                 | <b>5,847,569</b> | <b>5,803,208</b> |

**SHAREHOLDERS EQUITY**



|  |                     |                     |
|--|---------------------|---------------------|
| Common stock, \$1.00 par value; 250,000 shares authorized (shares issued:<br>2010 119,867 and 2009 118,724; outstanding: 2010 115,144 and 2009<br>114,051) | 119,867             | 118,724             |
| Additional paid-in capital   | 930,276             | 914,339             |
| Retained earnings  | 2,101,047           | 1,977,254           |
| Accumulated other comprehensive income   | 147,682             | 119,665             |
| Treasury stock, at cost (shares: 2010 4,723 and 2009 4,673)  | (100,022)           | (98,799)            |
| <b>Total shareholders equity</b>   | <b>3,198,850</b>    | <b>3,031,183</b>    |
| <b>Total liabilities and shareholders equity</b>   | <b>\$ 9,046,419</b> | <b>\$ 8,834,391</b> |

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Earnings**  
(unaudited, in thousands except per share data)

|  | Six months ended June 30, |                   | Three months ended June 30, |                  |
|--|---------------------------|-------------------|-----------------------------|------------------|
|  | 2010                      | 2009              | 2010                        | 2009             |
| <b>REVENUE</b>                                   |                           |                   |                             |                  |
| Net earned premium                               | \$ 1,015,972              | \$ 1,004,366      | \$ 506,385                  | \$ 501,978       |
| Fee and commission income                        | 40,168                    | 56,426            | 19,175                      | 26,132           |
| Net investment income                            | 99,466                    | 93,629            | 50,217                      | 48,411           |
| Other operating income                           | 11,993                    | 28,419            | 2,087                       | 5,523            |
| Net realized investment gain                     | 6,840                     | 3,988             | 2,315                       | 933              |
| Other-than-temporary impairment loss             |                           |                   |                             |                  |
| Total loss                                       |                           | (5,709)           |                             | (2,596)          |
| Portion recognized in other comprehensive income |                           | 755               |                             | 755              |
| Net loss recognized in earnings                  |                           | (4,954)           |                             | (1,841)          |
| <b>Total revenue</b>                             | <b>1,174,439</b>          | <b>1,181,874</b>  | <b>580,179</b>              | <b>581,136</b>   |
| <b>EXPENSE</b>                                   |                           |                   |                             |                  |
| Loss and loss adjustment expense, net            | 625,507                   | 608,136           | 298,986                     | 292,570          |
| Policy acquisition costs, net                    | 186,344                   | 178,940           | 93,688                      | 90,248           |
| Other operating expense                          | 129,183                   | 130,524           | 62,515                      | 61,526           |
| Interest expense                                 | 10,627                    | 8,267             | 5,237                       | 3,628            |
| <b>Total expense</b>                             | <b>951,661</b>            | <b>925,867</b>    | <b>460,426</b>              | <b>447,972</b>   |
| Earnings before income tax expense               | 222,778                   | 256,007           | 119,753                     | 133,164          |
| Income tax expense                               | 68,044                    | 81,252            | 36,373                      | 41,579           |
| <b>Net earnings</b>                              | <b>\$ 154,734</b>         | <b>\$ 174,755</b> | <b>\$ 83,380</b>            | <b>\$ 91,585</b> |
| <b>Earnings per common share</b>                 |                           |                   |                             |                  |
| Basic  | \$ 1.34                   | \$ 1.55           | \$ 0.72                     | \$ 0.81          |
| Diluted  | \$ 1.34                   | \$ 1.54           | \$ 0.72                     | \$ 0.81          |

See Notes to Condensed Consolidated Financial Statements.

6

---

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Condensed Consolidated Statement of Changes in Shareholders Equity**  
**(unaudited, in thousands except per share data)**

|  | <b>Common<br/>stock</b> | <b>Additional<br/>paid-in<br/>capital</b> | <b>Retained<br/>earnings</b> | <b>Accumulated<br/>other<br/>comprehensive<br/>income</b> | <b>Treasury<br/>stock</b> | <b>Total<br/>shareholders<br/>equity</b> |
|--|-------------------------|---|------------------------------|---|---------------------------|--|
| <b>Balance at December 31, 2009</b>                                  | \$ 118,724              | \$ 914,339                                | \$ 1,977,254                 | \$ 119,665  | \$ (98,799)               | \$ 3,031,183                             |
| Comprehensive income   |                         |   |                              |   |                           |  |
| Net earnings   |                         |   | 154,734                      |   |                           | 154,734                                  |
| Other comprehensive income   |                         |   |                              |   |                           |  |
| Change in unrealized gain on investments, net of tax                 |                         |   |                              | 44,237  |                           | 44,237                                   |
| Other, net of tax  |                         |   |                              | (16,220)  |                           | (16,220)                                 |
| Total other comprehensive income                                     |                         |   |                              |   |                           | 28,017                                   |
| Comprehensive income   |                         |   |                              |   |                           | 182,751                                  |
| Issuance of 506 shares for exercise of options, including tax effect | 506                     | 9,637                                     |                              |   |                           | 10,143                                   |
| Purchase of 50 common shares   |                         |   |                              |   | (1,223)                   | (1,223)                                  |
| Stock-based compensation   | 637                     | 6,300                                     |                              |   |                           | 6,937                                    |
| Cash dividends declared, \$0.27 per share                            |                         |   | (30,941)                     |   |                           | (30,941)                                 |
| <b>Balance at June 30, 2010</b>                                      | <b>\$ 119,867</b>       | <b>\$ 930,276</b>                         | <b>\$ 2,101,047</b>          | <b>\$ 147,682</b>   | <b>\$ (100,022)</b>       | <b>\$ 3,198,850</b>                      |

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Cash Flows**  
**(unaudited, in thousands)**

|   | <b>Six months ended June 30,</b> |                  |
|---|----------------------------------|------------------|
|   | <b>2010</b>                      | <b>2009</b>      |
| <b>Operating activities</b>   |                                  |                  |
| Net earnings  | \$ 154,734                       | \$ 174,755       |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                                  |                  |
| Change in premium, claims and other receivables                                     | (79,735)                         | (14,383)         |
| Change in reinsurance recoverables  | (60,013)                         | (24,117)         |
| Change in ceded unearned premium  | (4,630)                          | (25,841)         |
| Change in loss and loss adjustment expense payable                                  | 99,370                           | 97,956           |
| Change in reinsurance balances payable  | 3,253                            | 35,985           |
| Change in unearned premium  | 32,541                           | 67,388           |
| Change in premium and claims payable, net of restricted cash                        | 9,127                            | (59,802)         |
| Change in accounts payable and accrued liabilities                                  | (15,389)                         | 7,090            |
| Stock-based compensation expense  | 6,937                            | 8,906            |
| Depreciation and amortization expense   | 8,249                            | 7,652            |
| (Gain) loss on investments  | (7,329)                          | 1,924            |
| Other, net  | (7,789)                          | (15,337)         |
| <b>Cash provided by operating activities</b>  | <b>139,326</b>                   | <b>262,176</b>   |
| <b>Investing activities</b>   |                                  |                  |
| Sales of available for sale fixed income securities                                 | 133,856                          | 199,744          |
| Maturity or call of available for sale fixed income securities                      | 260,053                          | 160,470          |
| Maturity or call of held to maturity fixed income securities                        | 25,253                           | 85,991           |
| Cost of available for sale fixed income securities acquired                         | (703,341)                        | (570,529)        |
| Cost of held to maturity fixed income securities acquired                           | (96,383)                         | (59,580)         |
| Change in short-term investments  | 320,927                          | (160,119)        |
| Proceeds from sales of strategic and other investments                              | 4,577                            | 97,407           |
| Payments for purchase of businesses, net of cash received                           | (36,348)                         | (32,966)         |
| Proceeds from sale of subsidiaries  | 15,278                           | 5,500            |
| Other, net  | (9,405)                          | (8,916)          |
| <b>Cash used by investing activities</b>  | <b>(85,533)</b>                  | <b>(282,998)</b> |
| <b>Financing activities</b>   |                                  |                  |
| Advances on line of credit  |                                  | 105,000          |
| Payments on line of credit  |                                  | (15,032)         |
| Payments on convertible notes   | (64,472)                         |                  |
| Sale of common stock  | 10,143                           | 5,385            |
| Purchase of common stock  | (472)                            | (35,464)         |
| Dividends paid  | (30,983)                         | (28,204)         |
| Other, net  | (13,307)                         | (2,596)          |

|   |                  |                  |
|---|------------------|------------------|
| <b>Cash provided (used) by financing activities</b> | (99,091)         | 29,089           |
| Net increase (decrease) in cash                     | (45,298)         | 8,267            |
| Cash at beginning of year                           | 129,460          | 27,347           |
| <b>Cash at end of period</b>                        | <b>\$ 84,162</b> | <b>\$ 35,614</b> |

See Notes to Condensed Consolidated Financial Statements.

8

---

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

**(1) General Information**

HCC Insurance Holdings, Inc. and its subsidiaries (collectively, we, us or our) include domestic and foreign property and casualty and life insurance companies and underwriting agencies. We provide specialized property and casualty, surety and credit, and group life, accident and health insurance coverages and related agency services to commercial customers and individuals. We market our products both directly to customers and through a network of independent brokers, producers, agents and third party administrators. Our lines of business include diversified financial products (which includes directors and officers liability, errors and omissions liability (known as professional indemnity outside the U.S.), employment practices liability, surety, credit, and fidelity coverages); group life, accident and health (which includes medical stop-loss, short-term medical, occupational accident, and other coverages); aviation; our London market account (which includes energy, property, property treaty, marine, and accident and health coverages); and other specialty lines of insurance (which includes public entity, U.K. liability, event cancellation, contingency, and other coverages). We operate primarily in the United States, the United Kingdom, Spain and Ireland, although some of our operations have a broader international scope.

**Basis of Presentation**

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments that, in our opinion, are necessary for a fair statement of results of the interim periods, and all such adjustments are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The condensed consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2009. The condensed consolidated balance sheet at December 31, 2009 was derived from the audited financial statements, but does not include all disclosures required by GAAP.

Management must make estimates and assumptions that affect amounts reported in our condensed consolidated financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. We have reclassified certain amounts in our 2009 condensed consolidated financial statements to conform to the 2010 presentation. None of our reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

**Accounting Guidance in 2010**

A new accounting standard, originally issued as SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, became effective January 1, 2010. The guidance, which was incorporated into Accounting Standards Codification (ASC) Topic 810, *Consolidation*, changes various aspects of accounting for and disclosures of interests in variable interest entities. Our adoption of this guidance as of January 1, 2010 had no material impact on our condensed consolidated financial statements.

Effective January 1, 2010, we adopted Accounting Standards Update (ASU) No. 2010-06, which incorporated changes in disclosure requirements into ASC Topic 820, *Fair Value Measurements and Disclosures*. Where applicable, we have included the additional required disclosures in the notes to our condensed consolidated financial statements.

A new accounting standard, ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, was issued in July 2010. The new guidance expands disclosures related to financing

receivables, including the nature of credit risk in financing receivables, how that risk is analyzed in determining the related allowance for credit losses, and changes to the allowance during the reporting period. We will provide the additional required disclosures in our Form 10-K for the year ended December 31, 2010.

### **Derivative Financial Instruments**

At December 31, 2009, we had interests in two long-term mortgage impairment insurance contracts that were denominated in British pound sterling. The exposure with respect to these two contracts was measured based on movement in a specified United Kingdom housing index. In the first quarter of 2010, we commuted our interest in one contract for \$8.3 million cash. We recognized a gain of \$8.0 million, which is included in other operating income in our condensed consolidated statements of earnings. The remaining contract qualifies as a derivative financial instrument, is unhedged and is reported at fair value in other



**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

assets in our condensed consolidated balance sheets. We record changes in fair value and any foreign exchange gain/loss on this contract as a component of other operating income.

**Goodwill**

An indicator of impairment of goodwill exists when the fair value of a reporting unit is less than its carrying amount. We assess our goodwill for impairment annually, or sooner if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. We conducted our 2010 goodwill impairment test as of June 30, 2010, which is consistent with the timeframe for our annual assessment in prior years. Based on our latest impairment test, the fair value of each of our reporting units exceeded its carrying amount.

**Stock-based Compensation**

In the first six months of 2010, we granted the following shares of common stock, restricted stock, restricted stock units and stock options for the purchase of shares of our common stock. For all grants except stock options, we measure fair value based on our closing stock price on the grant date. For stock options, we use the Black-Scholes single option pricing model to determine the fair value of an option on its grant date. The fair value of the common stock was expensed on the grant date. The fair value of the restricted stock, restricted stock units and stock options will be expensed over the vesting period.

|                        | Number<br>of shares | Weighted-average<br>grant date<br>fair value | Aggregate<br>fair value | Vesting<br>period |
|------------------------|---------------------|--|-------------------------|-------------------|
| Common stock           | 33                  | \$ 25.33                                     | \$ 840                  |                   |
| Restricted stock       | 631                 | 28.07  | 17,732                  | 3-10<br>years     |
| Restricted stock units | 60                  | 25.96  | 1,555                   | 3-10<br>years     |
| Stock options          | 180                 | 6.55   | 1,178                   | 5<br>years        |

**Income Taxes**

For the six months ended June 30, 2010 and 2009, the income tax provision was calculated based on an estimated effective tax rate for each year. Our effective tax rate differs from the U.S. Federal statutory rate primarily due to the effect of tax-exempt municipal bond interest.

**Disposition**

In 2010, we sold an inactive subsidiary, HCC Insurance Company, for \$14.7 million cash and realized a \$0.5 million gain.

**(2) Fair Value Measurements**

We value financial assets and financial liabilities at fair value. In determining fair value, we generally apply the market approach, which uses prices and other relevant data based on market transactions involving identical or comparable assets and liabilities. We classify our financial instruments into the following three-level hierarchy:

Level 1 Inputs are based on quoted prices in active markets for identical instruments.

Level 2 Inputs are based on observable market data (other than quoted prices), or are derived from or corroborated by observable market data.

Level 3 Inputs are unobservable and not corroborated by market data.

Our Level 1 investments are primarily U.S. Treasuries listed on stock exchanges. We use quoted prices for identical instruments to measure fair value.

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

Our Level 2 investments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities, and certain mortgage-backed and asset-backed securities. Our Level 2 instruments also include our interest rate swap agreements, which are reflected as liabilities in our condensed consolidated balance sheets. We measure fair value for the majority of our Level 2 investments using quoted prices of securities with similar characteristics. The remaining investments are valued using pricing models or matrix pricing. The fair value measurements consider observable assumptions, including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, default rates, loss severity and other economic measures.

We use independent pricing services to assist us in determining fair value for over 99% of our Level 1 and Level 2 investments. The pricing services provide a single price or quote per security. We use data provided by our third party investment manager to value the remaining Level 2 investments. To validate that these quoted and modeled prices are reasonable estimates of fair value, we perform various quantitative and qualitative procedures, including: 1) evaluation of the underlying methodologies, 2) analysis of recent sales activity, 3) analytical review of our fair values against current market prices, and 4) comparison of the pricing services' fair value to other pricing services' fair value for the same investment. Based on these procedures, we did not adjust the prices or quotes provided by our independent pricing services or third party investment managers as of June 30, 2010 or December 31, 2009. In addition, we did not apply GAAP criteria for determining the fair value of securities in inactive markets since no markets for our investments were judged to be inactive as of June 30, 2010 or December 31, 2009.

Our Level 3 securities include certain fixed income securities, and an insurance contract that we account for as a derivative classified in other assets. We determine fair value based on internally developed models that use assumptions or other data that are not readily observable from objective sources. Because we use the lowest level significant input to determine our hierarchy classifications, a financial instrument may be classified in Level 3 even though there may be significant readily-observable inputs. In the first quarter of 2010, we commuted our interest in a second insurance contract that was accounted for as a derivative and also classified in other assets in Level 3 at December 31, 2009.

The following tables present our assets and interest rate swap liabilities that were measured at fair value.

|  | Level 1    | Level 2    | Level 3 | Total      |
|--|------------|------------|---------|------------|
| <u>June 30, 2010</u>   |            |            |         |            |
| Fixed income securities  |            |            |         |            |
| U.S. government and government agency securities                                   | \$ 169,556 | \$ 181,528 | \$      | \$ 351,084 |
| Fixed income securities of states, municipalities and political subdivisions       |            | 1,090,158  |         | 1,090,158  |
| Special purpose revenue bonds of states, municipalities and political subdivisions |            | 1,392,736  |         | 1,392,736  |
| Corporate fixed income securities  |            | 657,636    | 153     | 657,789    |
| Residential mortgage-backed securities   |            | 1,064,299  |         | 1,064,299  |
| Commercial mortgage-backed securities  |            | 145,359    | 2,543   | 147,902    |
| Asset-backed securities  |            | 10,269     | 1,277   | 11,546     |
| Foreign government securities  |            | 187,692    |         | 187,692    |
| Total fixed income securities  | 169,556    | 4,729,677  | 3,973   | 4,903,206  |
| Other investments  | 11         |            |         | 11         |

|   |            |              |          |              |
|---|------------|--------------|----------|--------------|
| Other assets                                    |            |              | 470      | 470          |
| <b>Total assets measured at fair value</b>      | \$ 169,567 | \$ 4,729,677 | \$ 4,443 | \$ 4,903,687 |
| Accounts payable and accrued liabilities        | \$         | \$ (1,122)   | \$       | \$ (1,122)   |
| <b>Total liabilities measured at fair value</b> | \$         | \$ (1,122)   | \$       | \$ (1,122)   |

11

---

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

|  | Level 1           | Level 2             | Level 3         | Total               |
|--|-------------------|---------------------|-----------------|---------------------|
| <u>December 31, 2009</u>   |                   |                     |                 |                     |
| Fixed income securities  |                   |                     |                 |                     |
| U.S. government and government agency securities                                   | \$ 178,927        | \$ 134,620          | \$              | \$ 313,547          |
| Fixed income securities of states, municipalities and political subdivisions       |                   | 1,059,426           |                 | 1,059,426           |
| Special purpose revenue bonds of states, municipalities and political subdivisions |                   | 1,146,334           |                 | 1,146,334           |
| Corporate fixed income securities  |                   | 686,170             | 151             | 686,321             |
| Residential mortgage-backed securities   |                   | 944,182             |                 | 944,182             |
| Commercial mortgage-backed securities  |                   | 143,412             | 2,805           | 146,217             |
| Asset-backed securities  |                   | 13,059              | 1,306           | 14,365              |
| Foreign government securities  |                   | 227,681             |                 | 227,681             |
| <b>Total fixed income securities</b>   | <b>178,927</b>    | <b>4,354,884</b>    | <b>4,262</b>    | <b>4,538,073</b>    |
| Other investments  | 14                |                     |                 | 14                  |
| Other assets   |                   |                     | 432             | 432                 |
| <b>Total assets measured at fair value</b>   | <b>\$ 178,941</b> | <b>\$ 4,354,884</b> | <b>\$ 4,694</b> | <b>\$ 4,538,519</b> |
| Accounts payable and accrued liabilities   | \$                | \$ (2,367)          | \$              | \$ (2,367)          |
| <b>Total liabilities measured at fair value</b>                                    | <b>\$</b>         | <b>\$ (2,367)</b>   | <b>\$</b>       | <b>\$ (2,367)</b>   |

We excluded from our fair value disclosures our held to maturity investment portfolio measured at amortized cost and two other investments measured at cost, which were redeemed in the second quarter of 2010. Our held to maturity portfolio had a fair value of \$174.7 million at June 30, 2010 and \$104.0 million at December 31, 2009. The two other investments collectively were valued at \$4.1 million at December 31, 2009.

The following table presents the changes in fair value of our Level 3 assets.

|                                     | 2010                          |                 |          | 2009                          |                 |           |
|-------------------------------------|-------------------------------|-----------------|----------|-------------------------------|-----------------|-----------|
|                                     | Fixed<br>income<br>securities | Other<br>assets | Total    | Fixed<br>income<br>securities | Other<br>assets | Total     |
| <b>Balance at beginning of year</b> | \$ 4,262                      | \$ 432          | \$ 4,694 | \$ 6,515                      | \$ 16,100       | \$ 22,615 |
| Net redemptions                     | (495)                         | (8,342)         | (8,837)  | (1,263)                       |                 | (1,263)   |
| Gains and (losses) unrealized       | 206                           | 38              | 244      | 531                           | 3,657           | 4,188     |
| Gains and (losses) realized         |                               | 8,342           | 8,342    | 30                            |                 | 30        |
| Transfers into Level 3              |                               |                 |          | 1,915                         |                 | 1,915     |
| Transfers out of Level 3            |                               |                 |          | (1,746)                       |                 | (1,746)   |

|                           |          |        |          |          |           |           |
|---------------------------|----------|--------|----------|----------|-----------|-----------|
| <b>Balance at June 30</b> | \$ 3,973 | \$ 470 | \$ 4,443 | \$ 5,982 | \$ 19,757 | \$ 25,739 |
|---------------------------|----------|--------|----------|----------|-----------|-----------|

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
(unaudited, tables in thousands except per share data)

|                               | 2010                          |                 |                 | 2009                          |                  |                  |
|-------------------------------|-------------------------------|-----------------|-----------------|-------------------------------|------------------|------------------|
|                               | Fixed<br>income<br>securities | Other<br>assets | Total           | Fixed<br>income<br>securities | Other<br>assets  | Total            |
| <b>Balance at March 31</b>    | \$ 4,224                      | \$ 291          | \$ 4,515        | \$ 5,085                      | \$ 16,463        | \$ 21,548        |
| Net redemptions               | (395)                         |                 | (395)           | (982)                         |                  | (982)            |
| Gains and (losses) unrealized | 144                           | 179             | 323             | (36)                          | 3,294            | 3,258            |
| Transfers into Level 3        |                               |                 |                 | 1,915                         |                  | 1,915            |
| <b>Balance at June 30</b>     | <b>\$ 3,973</b>               | <b>\$ 470</b>   | <b>\$ 4,443</b> | <b>\$ 5,982</b>               | <b>\$ 19,757</b> | <b>\$ 25,739</b> |

Unrealized gains and losses on our Level 3 fixed income securities are reported in other comprehensive income within shareholders' equity, and unrealized gains and losses on our Level 3 other assets are reported in other operating income. We transferred an investment into Level 3 in the second quarter of 2009 due to our inability to obtain a fair value using inputs based on observable market data. We transferred investments from Level 3 to Level 2 in 2009 because we were able to determine their fair value using inputs based on observable market data in the quarter transferred.

**(3) Investments**

Substantially all of our fixed income securities are investment grade and 97% are rated A or better. The cost or amortized cost, gross unrealized gain or loss, and fair value of investments in fixed income securities that are classified as available for sale were as follows:

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair value          |
|--|------------------------------|-----------------------------|-----------------------------|---------------------|
| <u>June 30, 2010</u>   |                              |                             |                             |                     |
| U.S. government and government agency securities                                   | \$ 340,147                   | \$ 10,937                   | \$                          | \$ 351,084          |
| Fixed income securities of states, municipalities and political subdivisions       | 1,036,365                    | 54,873                      | (1,080)                     | 1,090,158           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 1,337,135                    | 56,387                      | (786)                       | 1,392,736           |
| Corporate fixed income securities  | 625,600                      | 33,213                      | (1,024)                     | 657,789             |
| Residential mortgage-backed securities   | 1,007,753                    | 59,509                      | (2,963)                     | 1,064,299           |
| Commercial mortgage-backed securities  | 143,121                      | 5,641                       | (860)                       | 147,902             |
| Asset-backed securities  | 11,751                       | 607                         | (812)                       | 11,546              |
| Foreign government securities  | 176,391                      | 11,313                      | (12)                        | 187,692             |
| <b>Total available for sale fixed income securities</b>                            | <b>\$ 4,678,263</b>          | <b>\$ 232,480</b>           | <b>\$ (7,537)</b>           | <b>\$ 4,903,206</b> |

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
(unaudited, tables in thousands except per share data)

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair value          |
|--|------------------------------|-----------------------------|-----------------------------|---------------------|
| <u>December 31, 2009</u>   |                              |                             |                             |                     |
| U.S. government and government agency securities                                   | \$ 308,618                   | \$ 6,255                    | \$ (1,326)                  | \$ 313,547          |
| Fixed income securities of states, municipalities and political subdivisions       | 1,012,262                    | 49,491                      | (2,327)                     | 1,059,426           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 1,101,566                    | 46,551                      | (1,783)                     | 1,146,334           |
| Corporate fixed income securities  | 657,653                      | 28,785                      | (117)                       | 686,321             |
| Residential mortgage-backed securities   | 915,203                      | 35,130                      | (6,151)                     | 944,182             |
| Commercial mortgage-backed securities  | 151,357                      | 630                         | (5,770)                     | 146,217             |
| Asset-backed securities  | 15,118                       | 445                         | (1,198)                     | 14,365              |
| Foreign government securities  | 219,985                      | 7,914                       | (218)                       | 227,681             |
| <b>Total available for sale fixed income securities</b>                            | <b>\$ 4,381,762</b>          | <b>\$ 175,201</b>           | <b>\$ (18,890)</b>          | <b>\$ 4,538,073</b> |

The amortized cost and fair value of investments in fixed income securities that are classified as held to maturity were as follows:

|   | June 30, 2010     |                   | December 31, 2009 |                   |
|---|-------------------|-------------------|-------------------|-------------------|
|   | Amortized<br>cost | Fair value        | Amortized<br>cost | Fair value        |
| U.S. government and government agency securities      | \$ 19,812         | \$ 20,209         | \$ 14,988         | \$ 15,257         |
| Corporate fixed income securities                     | 93,383            | 94,111            | 7,594             | 7,685             |
| Foreign government securities                         | 59,154            | 60,333            | 80,210            | 81,066            |
| <b>Total held to maturity fixed income securities</b> | <b>\$ 172,349</b> | <b>\$ 174,653</b> | <b>\$ 102,792</b> | <b>\$ 104,008</b> |



**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

All fixed income securities were income producing in 2010. The following table displays the gross unrealized losses and fair value of all available for sale fixed income securities that were in a continuous unrealized loss position for the periods indicated.

|  | <b>Less than 12 months</b> |                   | <b>12 months or more</b> |                   | <b>Total</b>      |                   |
|--|----------------------------|-------------------|--------------------------|-------------------|-------------------|-------------------|
|  | <b>Unrealized</b>          |                   | <b>Unrealized</b>        |                   | <b>Unrealized</b> |                   |
|  | <b>Fair</b>                |                   | <b>Fair</b>              |                   | <b>Fair</b>       |                   |
|  | <b>value</b>               | <b>losses</b>     | <b>value</b>             | <b>losses</b>     | <b>value</b>      | <b>losses</b>     |
| <u>June 30, 2010</u>   |                            |                   |                          |                   |                   |                   |
| Fixed income securities of states, municipalities and political subdivisions       | \$ 38,338                  | \$ (465)          | \$ 11,833                | \$ (615)          | \$ 50,171         | \$ (1,080)        |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 79,536                     | (340)             | 23,150                   | (446)             | 102,686           | (786)             |
| Corporate fixed income securities  | 22,602                     | (1,024)           |                          |                   | 22,602            | (1,024)           |
| Residential mortgage-backed securities   | 12,822                     | (96)              | 37,822                   | (2,867)           | 50,644            | (2,963)           |
| Commercial mortgage-backed securities  | 1,224                      | (5)               | 16,551                   | (855)             | 17,775            | (860)             |
| Asset-backed securities  | 773                        | (147)             | 4,568                    | (665)             | 5,341             | (812)             |
| Foreign government securities  | 4,483                      | (12)              |                          |                   | 4,483             | (12)              |
| <b>Total</b>   | <b>\$ 159,778</b>          | <b>\$ (2,089)</b> | <b>\$ 93,924</b>         | <b>\$ (5,448)</b> | <b>\$ 253,702</b> | <b>\$ (7,537)</b> |
| <u>December 31, 2009</u>   |                            |                   |                          |                   |                   |                   |
| U.S. government and government agency securities                                   | \$ 101,542                 | \$ (1,326)        | \$                       | \$                | \$ 101,542        | \$ (1,326)        |
| Fixed income securities of states, municipalities and political subdivisions       | 48,836                     | (985)             | 19,816                   | (1,342)           | 68,652            | (2,327)           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 76,305                     | (1,305)           | 25,261                   | (478)             | 101,566           | (1,783)           |
|  | 13,773                     | (117)             |                          |                   | 13,773            | (117)             |

|  |                   |                   |                   |                    |                   |                    |
|--|-------------------|-------------------|-------------------|--------------------|-------------------|--------------------|
| Corporate fixed income securities      |                   |                   |                   |                    |                   |                    |
| Residential mortgage-backed securities | 147,621           | (2,018)           | 40,568            | (4,133)            | 188,189           | (6,151)            |
| Commercial mortgage-backed securities  | 30,209            | (418)             | 73,451            | (5,352)            | 103,660           | (5,770)            |
| Asset-backed securities                | 2,476             | (246)             | 7,532             | (952)              | 10,008            | (1,198)            |
| Foreign government securities          | 4,153             | (130)             | 8,593             | (88)               | 12,746            | (218)              |
| <b>Total</b>                           | <b>\$ 424,915</b> | <b>\$ (6,545)</b> | <b>\$ 175,221</b> | <b>\$ (12,345)</b> | <b>\$ 600,136</b> | <b>\$ (18,890)</b> |

A security has an impairment loss when its fair value is less than its cost or amortized cost at the balance sheet date. We evaluate the securities in our fixed income securities portfolio for possible other-than-temporary impairment losses at each quarter end. During 2010 and 2009, our reviews covered all impaired securities where the loss exceeded \$0.5 million and the loss either exceeded 10% of cost or the security had been in a loss position for longer than twelve consecutive months.

For other-than-temporary impairment losses, we recognize an other-than-temporary impairment loss in earnings in the period that we determine: 1) we intend to sell the security, 2) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis or 3) the security has a credit loss. We recognized no other-than-temporary impairment credit losses in 2010, compared to \$5.0 million and \$1.8 million in the six months and three months ended June 30, 2009, respectively.

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

Since April 1, 2009, when we adopted the new accounting standard for other-than-temporary impairment losses, we have recognized \$3.8 million in credit losses on impaired fixed income securities in earnings for which a portion of the total impairment was recorded in other comprehensive income. This amount has not changed since December 31, 2009 because we had no additional credit losses on these previously-impaired securities and no sales or maturities of these securities in 2010. We had \$5.0 million after-tax of other-than-temporary impairments, primarily related to mortgage-backed and asset-backed securities, included in accumulated other comprehensive income within shareholders' equity at June 30, 2010.

We do not consider the \$7.5 million of gross unrealized losses in our fixed income securities portfolio at June 30, 2010 to be other-than-temporary impairments as of that date because: 1) we received substantially all contractual interest and principal payments on these securities as of June 30, 2010, 2) we do not intend to sell the securities, 3) it is more likely than not that we will not be required to sell the securities before recovery of their amortized cost bases and 4) the unrealized loss relates to non-credit factors, such as interest rate changes and market conditions.

The amortized cost and fair value of our fixed income securities at June 30, 2010, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The weighted-average life of our mortgage-backed and asset-backed securities at June 30, 2010 was 2.8 years.

|   | Available for sale           |                     | Held to maturity  |                   |
|---|------------------------------|---------------------|-------------------|-------------------|
|   | Cost or<br>amortized<br>cost | Fair value          | Amortized<br>cost | Fair value        |
| Due in 1 year or less                       | \$ 268,234                   | \$ 272,713          | \$ 23,758         | \$ 23,981         |
| Due after 1 year through 5 years            | 1,070,303                    | 1,126,852           | 137,148           | 138,823           |
| Due after 5 years through 10 years          | 836,824                      | 887,794             | 11,443            | 11,849            |
| Due after 10 years through 15 years         | 726,382                      | 757,952             |                   |                   |
| Due after 15 years                          | 613,895                      | 634,148             |                   |                   |
| Securities with fixed maturities            | 3,515,638                    | 3,679,459           | 172,349           | 174,653           |
| Mortgage-backed and asset-backed securities | 1,162,625                    | 1,223,747           |                   |                   |
| <b>Total fixed income securities</b>        | <b>\$ 4,678,263</b>          | <b>\$ 4,903,206</b> | <b>\$ 172,349</b> | <b>\$ 174,653</b> |

The sources of net investment income were as follows:

|                         | Six months ended June<br>30, |           | Three months ended June<br>30, |           |
|-------------------------|------------------------------|-----------|--------------------------------|-----------|
|                         | 2010                         | 2009      | 2010                           | 2009      |
| Fixed income securities | \$ 99,080                    | \$ 92,912 | \$ 50,481                      | \$ 47,474 |
| Short-term investments  | 360                          | 1,470     | 170                            | 586       |
| Other                   | 2,042                        | 1,051     | 534                            | 1,103     |
| Total investment income | 101,482                      | 95,433    | 51,185                         | 49,163    |
| Investment expense      | (2,016)                      | (1,804)   | (968)                          | (752)     |

|                              |           |           |           |           |
|------------------------------|-----------|-----------|-----------|-----------|
| <b>Net investment income</b> | \$ 99,466 | \$ 93,629 | \$ 50,217 | \$ 48,411 |
|------------------------------|-----------|-----------|-----------|-----------|

16

---

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

Realized pretax gains (losses) on the sale of investments, which exclude other-than-temporary impairment losses, were as follows:

|  | <b>Six months ended June 30,</b> |                 |                 |                 |                   |                 |
|--|----------------------------------|-----------------|-----------------|-----------------|-------------------|-----------------|
|  |                                  | <b>2010</b>     |                 | <b>2009</b>     |                   |                 |
|  | <b>Gains</b>                     | <b>Losses</b>   | <b>Net</b>      | <b>Gains</b>    | <b>Losses</b>     | <b>Net</b>      |
| Fixed income securities                | \$ 7,593                         | \$ (599)        | \$ 6,994        | \$ 5,633        | \$ (2,167)        | \$ 3,466        |
| Other                                  | 2                                | (156)           | (154)           | 683             | (161)             | 522             |
| <b>Realized investment gain (loss)</b> | <b>\$ 7,595</b>                  | <b>\$ (755)</b> | <b>\$ 6,840</b> | <b>\$ 6,316</b> | <b>\$ (2,328)</b> | <b>\$ 3,988</b> |

|  | <b>Three months ended June 30,</b> |                 |                 |                 |                   |               |
|--|------------------------------------|-----------------|-----------------|-----------------|-------------------|---------------|
|  |                                    | <b>2010</b>     |                 | <b>2009</b>     |                   |               |
|  | <b>Gains</b>                       | <b>Losses</b>   | <b>Net</b>      | <b>Gains</b>    | <b>Losses</b>     | <b>Net</b>    |
| Fixed income securities                | \$ 2,692                           | \$ (376)        | \$ 2,316        | \$ 1,967        | \$ (1,020)        | \$ 947        |
| Other                                  |                                    | (1)             | (1)             |                 | (14)              | (14)          |
| <b>Realized investment gain (loss)</b> | <b>\$ 2,692</b>                    | <b>\$ (377)</b> | <b>\$ 2,315</b> | <b>\$ 1,967</b> | <b>\$ (1,034)</b> | <b>\$ 933</b> |

**(4) Earnings Per Share**

The following table details the numerator and denominator used in our earnings per share calculations.

|   | <b>Six months ended June 30,</b> |                   | <b>Three months ended June 30,</b> |                  |
|---|----------------------------------|-------------------|------------------------------------|------------------|
|   | <b>2010</b>                      | <b>2009</b>       | <b>2010</b>                        | <b>2009</b>      |
| Net earnings  | \$ 154,734                       | \$ 174,755        | \$ 83,380                          | \$ 91,585        |
| Less: net earnings attributable to unvested restricted stock and restricted stock units | (1,679)                          | (899)             | (927)                              | (503)            |
| <b>Net earnings available to common stock</b>   | <b>\$ 153,055</b>                | <b>\$ 173,856</b> | <b>\$ 82,453</b>                   | <b>\$ 91,082</b> |
| Weighted-average common shares outstanding  | 113,805                          | 112,286           | 113,935                            | 111,776          |
| Dilutive effect of outstanding options (determined using treasury stock method)         | 322                              | 259               | 253                                | 277              |
| Dilutive effect of convertible debt (determined using treasury stock method)            |                                  | 365               |                                    | 467              |
|   | 114,127                          | 112,910           | 114,188                            | 112,520          |

**Weighted-average common shares and  
potential common shares outstanding**

|  |       |       |       |       |
|--|-------|-------|-------|-------|
| Anti-dilutive stock options not included in<br>treasury stock method computation | 4,392 | 6,336 | 4,680 | 5,734 |
|--|-------|-------|-------|-------|

17

---

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(unaudited, tables in thousands except per share data)**

**(5) Segment and Geographic Data**

The performance of each segment is evaluated by our management based on net earnings. Net earnings is calculated on an after-tax basis and after corporate expense allocations, interest expense on debt incurred for acquired companies and intercompany eliminations have been charged or credited to our individual segments. All stock-based compensation is included in the corporate segment because it is not included in management's evaluation of the other segments. All contractual and discretionary bonuses are expensed in the respective employee's segment in the year the bonuses are earned. Any such bonuses that will be paid by restricted stock awards, which will be granted by the Compensation Committee in the following year, are reversed on the corporate segment, which will record the appropriate stock-based compensation expense as the awards vest in future years. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated.

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
(unaudited, tables in thousands except per share data)

| Six months ended June 30,<br>2010            | <b>Insurance<br/>company</b> | <b>Agency</b>      | <b>Other<br/>operations</b> | <b>Corporate</b>    | <b>Total</b>        |
|--|------------------------------|--------------------|-----------------------------|---------------------|---------------------|
| Revenue:                                     |                              |                    |                             |                     |                     |
| Domestic                                     | \$ 906,448                   | \$ 22,375          | \$ 3,455                    | \$ 1,362            | \$ 933,640          |
| Foreign                                      | 235,417                      | 5,382              |                             |                     | 240,799             |
| Inter-segment                                |                              | 39,353             | 473                         |                     | 39,826              |
| <b>Total segment revenue</b>                 | <b>\$ 1,141,865</b>          | <b>\$ 67,110</b>   | <b>\$ 3,928</b>             | <b>\$ 1,362</b>     | <b>1,214,265</b>    |
| Inter-segment eliminations                   |                              |                    |                             |                     | (39,826 )           |
| <b>Consolidated total revenue</b>            |                              |                    |                             |                     | <b>\$ 1,174,439</b> |
| Net earnings (loss):                         |                              |                    |                             |                     |                     |
| Domestic                                     | \$ 137,331                   | \$ (683 )          | \$ 1,385                    | \$ (14,496 )        | \$ 123,537          |
| Foreign                                      | 28,489                       | (715 )             |                             |                     | 27,774              |
| <b>Total segment net earnings<br/>(loss)</b> | <b>\$ 165,820</b>            | <b>\$ (1,398 )</b> | <b>\$ 1,385</b>             | <b>\$ (14,496 )</b> | <b>151,311</b>      |
| Inter-segment eliminations                   |                              |                    |                             |                     | 3,423               |
| <b>Consolidated net earnings</b>             |                              |                    |                             |                     | <b>\$ 154,734</b>   |
| Other items:                                 |                              |                    |                             |                     |                     |
| Net investment income                        | \$ 97,978                    | \$ 117             | \$ 1                        | \$ 1,370            | \$ 99,466           |
| Depreciation and amortization                | 2,545                        | 3,732              | 45                          | 1,927               | 8,249               |



Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

|                                 |           |           |        |             |           |
|---------------------------------|-----------|-----------|--------|-------------|-----------|
| Interest expense                | 363       | 7,815     |        | 2,449       | 10,627    |
| Capital expenditures            | 986       | 1,768     | 1      | 6,650       | 9,405     |
| Tax expense:                    |           |           |        |             |           |
| Income tax expense (benefit)    | \$ 67,808 | \$ (284 ) | \$ 503 | \$ (2,371 ) | \$ 65,656 |
| Inter-segment eliminations      |           |           |        |             | 2,388     |
|                                 |           |           |        |             |           |
| Consolidated income tax expense |           |           |        |             | \$ 68,044 |

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
(unaudited, tables in thousands except per share data)

| Six months ended June 30,<br>2009            | <b>Insurance<br/>company</b> | <b>Agency</b>    | <b>Other<br/>operations</b> | <b>Corporate</b>    | <b>Total</b>        |
|--|------------------------------|------------------|-----------------------------|---------------------|---------------------|
| Revenue:                                     |                              |                  |                             |                     |                     |
| Domestic                                     | \$ 924,553                   | \$ 30,989        | \$ 4,737                    | \$ 1,521            | \$ 961,800          |
| Foreign                                      | 207,800                      | 12,274           |                             |                     | 220,074             |
| Inter-segment                                |                              | 50,803           | 487                         |                     | 51,290              |
| <b>Total segment revenue</b>                 | <b>\$ 1,132,353</b>          | <b>\$ 94,066</b> | <b>\$ 5,224</b>             | <b>\$ 1,521</b>     | <b>1,233,164</b>    |
| Inter-segment eliminations                   |                              |                  |                             |                     | (51,290 )           |
| <b>Consolidated total revenue</b>            |                              |                  |                             |                     | <b>\$ 1,181,874</b> |
| Net earnings (loss):                         |                              |                  |                             |                     |                     |
| Domestic                                     | \$ 138,925                   | \$ 7,379         | \$ 2,161                    | \$ (13,664 )        | \$ 134,801          |
| Foreign                                      | 38,257                       | 1,134            |                             |                     | 39,391              |
| <b>Total segment net earnings<br/>(loss)</b> | <b>\$ 177,182</b>            | <b>\$ 8,513</b>  | <b>\$ 2,161</b>             | <b>\$ (13,664 )</b> | <b>174,192</b>      |
| Inter-segment eliminations                   |                              |                  |                             |                     | 563                 |
| <b>Consolidated net earnings</b>             |                              |                  |                             |                     | <b>\$ 174,755</b>   |
| Other items:                                 |                              |                  |                             |                     |                     |
| Net investment income                        | \$ 91,727                    | \$ 334           | \$ 7                        | \$ 1,561            | \$ 93,629           |
| Depreciation and amortization                | 2,576                        | 3,669            | 44                          | 1,363               | 7,652               |

Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

|                                 |           |          |          |             |           |
|---------------------------------|-----------|----------|----------|-------------|-----------|
| Interest expense (benefit)      | 537       | 7,343    | (13 )    | 400         | 8,267     |
| Capital expenditures            | 2,156     | 3,686    | 13       | 3,061       | 8,916     |
| Tax expense:                    |           |          |          |             |           |
| Income tax expense (benefit)    | \$ 77,614 | \$ 6,739 | \$ 1,148 | \$ (4,454 ) | \$ 81,047 |
| Inter-segment eliminations      |           |          |          |             | 205       |
|                                 |           |          |          |             |           |
| Consolidated income tax expense |           |          |          |             | \$ 81,252 |

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
(unaudited, tables in thousands except per share data)

| Three months ended June 30,<br>2010          | <b>Insurance<br/>company</b> | <b>Agency</b>    | <b>Other<br/>operations</b> | <b>Corporate</b>   | <b>Total</b>      |
|--|------------------------------|------------------|-----------------------------|--------------------|-------------------|
| Revenue:                                     |                              |                  |                             |                    |                   |
| Domestic                                     | \$ 445,970                   | \$ 11,449        | \$ 1,536                    | \$ 679             | \$ 459,634        |
| Foreign                                      | 118,454                      | 2,091            |                             |                    | 120,545           |
| Inter-segment                                |                              | 24,646           | 288                         |                    | 24,934            |
| <b>Total segment revenue</b>                 | <b>\$ 564,424</b>            | <b>\$ 38,186</b> | <b>\$ 1,824</b>             | <b>\$ 679</b>      | <b>605,113</b>    |
| Inter-segment eliminations                   |                              |                  |                             |                    | (24,934 )         |
| <b>Consolidated total revenue</b>            |                              |                  |                             |                    | <b>\$ 580,179</b> |
| Net earnings (loss):                         |                              |                  |                             |                    |                   |
| Domestic                                     | \$ 66,637                    | \$ 2,643         | \$ 570                      | \$ (9,045 )        | \$ 60,805         |
| Foreign                                      | 22,499                       | 374              |                             |                    | 22,873            |
| <b>Total segment net earnings<br/>(loss)</b> | <b>\$ 89,136</b>             | <b>\$ 3,017</b>  | <b>\$ 570</b>               | <b>\$ (9,045 )</b> | <b>83,678</b>     |
| Inter-segment eliminations                   |                              |                  |                             |                    | (298 )            |
| <b>Consolidated net earnings</b>             |                              |                  |                             |                    | <b>\$ 83,380</b>  |
| Other items:                                 |                              |                  |                             |                    |                   |
| Net investment income                        | \$ 49,480                    | \$ 58            | \$                          | \$ 679             | \$ 50,217         |
| Depreciation and amortization                | 1,375                        | 1,877            | 23                          | 1,003              | 4,278             |

Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

|                                 |           |          |        |             |           |
|---------------------------------|-----------|----------|--------|-------------|-----------|
| Interest expense                | 103       | 3,569    |        | 1,565       | 5,237     |
| Capital expenditures            | 179       | 879      |        | 4,523       | 5,581     |
| Tax expense:                    |           |          |        |             |           |
| Income tax expense (benefit)    | \$ 35,276 | \$ 2,510 | \$ 247 | \$ (1,646 ) | \$ 36,387 |
| Inter-segment eliminations      |           |          |        |             | (14 )     |
|                                 |           |          |        |             |           |
| Consolidated income tax expense |           |          |        |             | \$ 36,373 |

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
(unaudited, tables in thousands except per share data)

| Three months ended June 30,<br>2009          | <b>Insurance<br/>company</b> | <b>Agency</b>    | <b>Other<br/>operations</b> | <b>Corporate</b>   | <b>Total</b>      |
|--|------------------------------|------------------|-----------------------------|--------------------|-------------------|
| Revenue:                                     |                              |                  |                             |                    |                   |
| Domestic                                     | \$ 454,167                   | \$ 12,979        | \$ 2,459                    | \$ 869             | \$ 470,474        |
| Foreign                                      | 104,697                      | 5,965            |                             |                    | 110,662           |
| Inter-segment                                |                              | 27,056           | 233                         |                    | 27,289            |
| <b>Total segment revenue</b>                 | <b>\$ 558,864</b>            | <b>\$ 46,000</b> | <b>\$ 2,692</b>             | <b>\$ 869</b>      | <b>608,425</b>    |
| Inter-segment eliminations                   |                              |                  |                             |                    | (27,289 )         |
| <b>Consolidated total revenue</b>            |                              |                  |                             |                    | <b>\$ 581,136</b> |
| Net earnings (loss):                         |                              |                  |                             |                    |                   |
| Domestic                                     | \$ 69,012                    | \$ 4,218         | \$ 1,148                    | \$ (6,058 )        | \$ 68,320         |
| Foreign                                      | 22,255                       | 919              |                             |                    | 23,174            |
| <b>Total segment net earnings<br/>(loss)</b> | <b>\$ 91,267</b>             | <b>\$ 5,137</b>  | <b>\$ 1,148</b>             | <b>\$ (6,058 )</b> | <b>91,494</b>     |
| Inter-segment eliminations                   |                              |                  |                             |                    | 91                |
| <b>Consolidated net earnings</b>             |                              |                  |                             |                    | <b>\$ 91,585</b>  |
| Other items:                                 |                              |                  |                             |                    |                   |
| Net investment income                        | \$ 47,507                    | \$ 124           | \$ 3                        | \$ 777             | \$ 48,411         |
| Depreciation and amortization                | 1,450                        | 1,922            | 22                          | 679                | 4,073             |

Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

|                                 |           |          |        |             |           |
|---------------------------------|-----------|----------|--------|-------------|-----------|
| Interest expense (benefit)      | 258       | 3,609    | (6 )   | (233 )      | 3,628     |
| Capital expenditures            | 1,660     | 1,598    | 3      | 2,173       | 5,434     |
| Tax expense:                    |           |          |        |             |           |
| Income tax expense (benefit)    | \$ 39,378 | \$ 3,363 | \$ 559 | \$ (1,975 ) | \$ 41,325 |
| Inter-segment eliminations      |           |          |        |             | 254       |
|                                 |           |          |        |             |           |
| Consolidated income tax expense |           |          |        |             | \$ 41,579 |

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

The following tables present selected revenue items by line of business and major product lines.

|                                 | <b>Six months ended June 30,</b> |                     | <b>Three months ended June 30,</b> |                   |
|---------------------------------|----------------------------------|---------------------|------------------------------------|-------------------|
|                                 | <b>2010</b>                      | <b>2009</b>         | <b>2010</b>                        | <b>2009</b>       |
| Diversified financial products  |                                  |                     |                                    |                   |
| Directors and officers          | \$ 183,639                       | \$ 172,488          | \$ 90,721                          | \$ 89,686         |
| Errors and omissions            | 106,691                          | 118,282             | 52,798                             | 58,877            |
| Other                           | 21,364                           | 20,767              | 9,538                              | 9,791             |
| U.S. surety and credit          | 98,620                           | 89,727              | 51,871                             | 45,235            |
| International surety and credit | 35,884                           | 32,651              | 17,695                             | 16,242            |
|                                 | 446,198                          | 433,915             | 222,623                            | 219,831           |
| Group life, accident and health |                                  |                     |                                    |                   |
| Medical stop-loss               | 323,558                          | 315,842             | 161,792                            | 156,359           |
| Other medical                   | 50,618                           | 66,229              | 25,597                             | 33,176            |
| Other                           | 12,597                           | 16,100              | 5,742                              | 7,548             |
|                                 | 386,773                          | 398,171             | 193,131                            | 197,083           |
| Aviation                        | 58,298                           | 65,461              | 29,355                             | 32,647            |
| London market account           |                                  |                     |                                    |                   |
| Energy                          | 26,789                           | 22,439              | 10,602                             | 13,204            |
| Property treaty                 | 15,609                           | 26,940              | 8,855                              | 12,501            |
| Other                           | 29,215                           | 26,940              | 15,988                             | 12,501            |
|                                 | 71,613                           | 49,379              | 35,445                             | 25,705            |
| Other specialty lines           |                                  |                     |                                    |                   |
| Public risk                     | 22,926                           | 17,807              | 11,436                             | 9,187             |
| HCC Lloyd's                     | 19,187                           | 20,940              | 9,002                              | 10,150            |
| Other                           | 10,945                           | 18,703              | 5,403                              | 7,389             |
|                                 | 53,058                           | 57,450              | 25,841                             | 26,726            |
| Discontinued lines              | 32                               | (10)                | (10)                               | (14)              |
| <b>Total net earned premium</b> | <b>\$ 1,015,972</b>              | <b>\$ 1,004,366</b> | <b>\$ 506,385</b>                  | <b>\$ 501,978</b> |



|                                  |                  |                  |                  |                  |
|----------------------------------|------------------|------------------|------------------|------------------|
| Property and casualty            | \$ 34,326        | \$ 45,697        | \$ 16,646        | \$ 21,279        |
| Accident and health              | 5,842            | 10,729           | 2,529            | 4,853            |
| <b>Fee and commission income</b> | <b>\$ 40,168</b> | <b>\$ 56,426</b> | <b>\$ 19,175</b> | <b>\$ 26,132</b> |

23

---

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

**(6) Reinsurance**

In the normal course of business, our insurance companies cede a portion of their premium to domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although ceding for reinsurance purposes does not discharge the direct insurer from liability to its policyholder, our insurance companies participate in such agreements in order to limit their loss exposure, protect them against catastrophic loss and diversify their business. The following table presents the effect of such reinsurance transactions on our premium and loss and loss adjustment expense.

|   | <b>Written<br/>premium</b> | <b>Earned<br/>premium</b> | <b>Loss and<br/>loss<br/>adjustment<br/>expense</b> |
|---|----------------------------|---------------------------|---|
| <u>Six months ended June 30, 2010</u>   |                            |                           |   |
| Direct business                         | \$ 1,131,637               | \$ 1,139,036              | \$ 718,869  |
| Reinsurance assumed                     | 182,437                    | 141,148                   | 105,789   |
| Reinsurance ceded                       | (269,021)                  | (264,212)                 | (199,151)   |
| <b>Net amounts</b>                      | <b>\$ 1,045,053</b>        | <b>\$ 1,015,972</b>       | <b>\$ 625,507</b>                                   |
| <u>Six months ended June 30, 2009</u>   |                            |                           |   |
| Direct business                         | \$ 1,150,471               | \$ 1,105,248              | \$ 696,623  |
| Reinsurance assumed                     | 133,233                    | 124,963                   | 65,003  |
| Reinsurance ceded                       | (249,102)                  | (225,845)                 | (153,490)   |
| <b>Net amounts</b>                      | <b>\$ 1,034,602</b>        | <b>\$ 1,004,366</b>       | <b>\$ 608,136</b>                                   |
| <u>Three months ended June 30, 2010</u> |                            |                           |   |
| Direct business                         | \$ 622,445                 | \$ 567,074                | \$ 357,918  |
| Reinsurance assumed                     | 69,133                     | 71,908                    | 52,954  |
| Reinsurance ceded                       | (144,776)                  | (132,597)                 | (111,886)   |
| <b>Net amounts</b>                      | <b>\$ 546,802</b>          | <b>\$ 506,385</b>         | <b>\$ 298,986</b>                                   |
| <u>Three months ended June 30, 2009</u> |                            |                           |   |
| Direct business                         | \$ 618,439                 | \$ 556,211                | \$ 334,353  |
| Reinsurance assumed                     | 62,878                     | 60,823                    | 28,338  |

|                    |                   |                   |                   |
|--------------------|-------------------|-------------------|-------------------|
| Reinsurance ceded  | (137,965)         | (115,056)         | (70,121)          |
| <b>Net amounts</b> | <b>\$ 543,352</b> | <b>\$ 501,978</b> | <b>\$ 292,570</b> |

Ceding commissions that are netted against policy acquisition costs in the condensed consolidated statements of earnings were \$32.6 million and \$25.4 million for the six months ended June 30, 2010 and 2009, respectively. The comparable amounts were \$16.2 million and \$12.9 million for the second quarter of 2010 and 2009, respectively.

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited, tables in thousands except per share data)**

The table below shows the components of reinsurance recoverables in our condensed consolidated balance sheets.

|   | <b>June 30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|--------------------------|----------------------------------|
| Reinsurance recoverable on paid losses                      | \$ 97,315                | \$ 82,887                        |
| Reinsurance recoverable on outstanding losses               | 485,101                  | 495,964                          |
| Reinsurance recoverable on incurred but not reported losses | 475,188                  | 440,505                          |
| Reserve for uncollectible reinsurance                       | (2,945)                  | (2,945)                          |
| <b>Total reinsurance recoverables</b>                       | <b>\$ 1,054,659</b>      | <b>\$ 1,016,411</b>              |

The tables below present the calculation of net reserves, net unearned premium and net deferred policy acquisition costs.

|   | <b>June 30,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|--------------------------|----------------------------------|
| Loss and loss adjustment expense payable                    | \$ 3,528,606             | \$ 3,492,309                     |
| Reinsurance recoverable on outstanding losses               | (485,101)                | (495,964)                        |
| Reinsurance recoverable on incurred but not reported losses | (475,188)                | (440,505)                        |
| <b>Net reserves</b>   | <b>\$ 2,568,317</b>      | <b>\$ 2,555,840</b>              |
| Unearned premium  | \$ 1,069,355             | \$ 1,044,747                     |
| Ceded unearned premium                                      | (271,783)                | (270,436)                        |
| <b>Net unearned premium</b>                                 | <b>\$ 797,572</b>        | <b>\$ 774,311</b>                |
| Deferred policy acquisition costs                           | \$ 216,988               | \$ 208,463                       |
| Deferred ceding commissions                                 | (68,657)                 | (71,595)                         |
| <b>Net deferred policy acquisition costs</b>                | <b>\$ 148,331</b>        | <b>\$ 136,868</b>                |

**(7) Supplemental Information**

Supplemental information was as follows:

| <b>Six months ended June 30,</b> |             | <b>Three months ended June<br/>30,</b> |             |
|----------------------------------|-------------|--|-------------|
| <b>2010</b>                      | <b>2009</b> | <b>2010</b>                            | <b>2009</b> |

Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Income taxes paid  | \$ 66,215 | \$ 88,816 | \$ 53,365 | \$ 68,602 |
| Interest paid  | 9,563     | 6,249     | 9,341     | 2,807     |
| Proceeds from sales of available for sale<br>fixed income securities | 133,856   | 199,744   | 66,167    | 80,652    |
| Comprehensive income   | 182,751   | 218,707   | 114,814   | 111,171   |
|  | 25        |           |           |           |

---

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(unaudited, tables in thousands except per share data)**

**(8) Commitments and Contingencies**

**Catastrophe and Large Loss Exposure**

We have exposure to catastrophic losses caused by natural perils (such as hurricanes and earthquakes), as well as from man-made events (such as terrorist attacks). The incidence, timing and severity of catastrophic losses are unpredictable. We assess our exposures in areas most vulnerable to natural catastrophes and apply procedures to ascertain our probable maximum loss from a single event. We maintain reinsurance protection that we believe is sufficient to limit our exposure to a foreseeable event. In the first quarter of 2010, we recognized gross losses from catastrophic events, primarily the Chilean earthquake, of \$31.9 million. After reinsurance, our pretax loss was \$20.6 million. In the second quarter of 2010, we recognized gross losses for the Deepwater Horizon rig disaster of \$28.2 million. Due to significant facultative reinsurance, our pretax net loss was minimal.

**Litigation**

We are a party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of any such matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

**Indemnifications**

In conjunction with the sales of business assets and subsidiaries, we have provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to our responsibilities to perform under the sales contracts. Under other indemnifications, we agree to reimburse the purchasers for taxes or ERISA-related amounts, if any, assessed after the sale date but related to pre-sale activities. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires in 2025. We accrue a loss when a valid claim is made by a purchaser and we believe we have potential exposure. At June 30, 2010, we have recorded a liability of \$11.8 million and have provided a \$3.0 million escrow account and \$9.7 million of letters of credit to cover our obligations or anticipated payments under these indemnifications.

**Table of Contents**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following Management's Discussion and Analysis should be read in conjunction with the Condensed Consolidated Financial Statements and the related Notes thereto.

**Overview**

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain and Ireland, transacting business in approximately 150 countries. Our group consists of insurance companies, underwriting agencies and 100% participation in an active Lloyd's of London syndicate that we manage. Our shares trade on the New York Stock Exchange and closed at \$24.76 on June 30, 2010. We had a market capitalization of \$2.9 billion at July 31, 2010.

We underwrite a variety of relatively non-correlated specialty lines of business identified as diversified financial products; group life, accident and health; aviation; London market account; and other specialty lines of business. Products in each segment are marketed by our insurance companies, agencies and the syndicate through a network of independent agents and brokers, directly to customers or through third party administrators. The majority of our business is low limit or small premium business that has less intense price competition, as well as lower catastrophe and volatility risk. We reinsure a significant portion of our catastrophic exposure to hurricanes, earthquakes and large losses to minimize the impact on our net earnings and shareholders' equity.

Our major domestic and international insurance companies have a financial strength rating of AA (Very Strong) from Standard & Poor's Corporation. Our major domestic insurance companies have a financial strength rating of AA (Very Strong) from Fitch Ratings, A1 (Good Security) from Moody's Investors Service, Inc., and A+ (Superior) from A.M. Best Company, Inc.

Key facts about our consolidated group as of and for the six months and quarter ended June 30, 2010 are as follows:

We had consolidated shareholders' equity of \$3.2 billion. Our book value per share increased in the first six months to \$27.78.

We had year-to-date net earnings of \$154.7 million, or \$1.34 per diluted share. Our second quarter earnings were \$83.4 million, or \$0.72 per diluted share.

We produced total revenue of \$1.2 billion and \$580.2 million in the first half and second quarter, respectively.

In the first quarter, we recognized gross losses from catastrophic events, primarily from the Chilean earthquake, of \$31.9 million. After reinsurance, our pretax loss was \$20.6 million. In the second quarter, we recognized gross losses for the Deepwater Horizon rig disaster of \$28.2 million. Due to significant facultative reinsurance, our pretax net loss was minimal. The catastrophe losses increased our net loss ratio and combined ratio by 2.0 percentage points and decreased net earnings by \$0.12 per diluted share for the six-month period.

Our year-to-date net loss ratio, including the catastrophic losses, was 61.6% and our combined ratio was 88.0%.

We declared dividends of \$0.27 per share and paid \$31.0 million of dividends in the first six months of 2010.

We hold a \$5.1 billion portfolio of fixed income securities with an average rating of AA+, and a total investment portfolio of \$5.6 billion.

We purchased \$1.2 million of our common stock at an average cost of \$24.38 per share during the quarter. Comparisons in the following sections refer to the first six months of 2010 compared to the same period of 2009, unless otherwise noted. Amounts in tables are in thousands, except for earnings per share, percentages, ratios and

number of employees.

**Results of Operations**

Net earnings were \$154.7 million (\$1.34 per diluted share) in the first half of 2010, compared to \$174.8 million (\$1.54 per diluted share) in the same period of 2009 and \$83.4 million (\$0.72 per diluted share) in the second quarter of 2010, compared to \$91.6 million



**Table of Contents**

(\$0.81 per diluted share) in the second quarter of 2009. Net earnings for the first six months of 2010 included \$20.6 million (pretax) of net catastrophic losses, primarily from the Chilean earthquake, partially offset by a \$5.0 million pretax gain, net of related expenses, that we realized from commuting a derivative contract. The year-to-date 2009 net earnings included a \$15.6 million pretax gain, net of related expenses, from the commutation of a reinsurance contract with Mortgage Guarantee Insurance Corporation (MGIC). Net earnings decreased quarter-over-quarter primarily due to redundant reserve development in the 2009 quarter.

These items are described more fully below:

We had net adverse reserve development of \$2.2 million in the first six months of 2010, compared to \$11.3 million of net redundant development in first six months of 2009. We had net redundant development of \$2.8 million in the second quarter of 2010, compared to \$16.0 million in the comparable 2009 period. See the **Losses and Loss Adjustment Expenses** section below for further discussion of these reserve changes.

In the first quarter of 2010, we commuted our interest in a long-term mortgage impairment insurance contract that had been accounted for as a derivative financial instrument. The contract was denominated in British pound sterling. We received £5.6 million (\$8.3 million) of cash and recognized a gain of \$8.0 million, which was included in other operating income, and incurred related expenses of \$3.0 million, which were included in other operating expense in the year-to-date condensed consolidated statements of earnings.

In the first quarter of 2009, we commuted, loss-free, all liability under a contract with MGIC to provide reinsurance coverage for certain residential mortgage guaranty contracts. We had been recording revenue under this contract using the deposit method of accounting because we determined the contract did not transfer significant underwriting risk. We received a cash termination payment of \$25.0 million. As a result of the termination, our year-to-date other operating income increased \$20.5 million, and fee and commission income increased \$5.0 million. This additional revenue was partially offset by \$9.9 million of expenses for reinsurance and other direct costs, which were recorded in other operating expense.

The following table sets forth the relationships of income statement line items as a percent of total revenue.

|                                       | Six months ended June 30, |              | Three months ended June 30, |              |
|---------------------------------------|---------------------------|--------------|-----------------------------|--------------|
|                                       | 2010                      | 2009         | 2010                        | 2009         |
| Net earned premium                    | 86.5%                     | 85.0%        | 87.3%                       | 86.4%        |
| Fee and commission income             | 3.4                       | 4.8          | 3.3                         | 4.5          |
| Net investment income                 | 8.5                       | 7.9          | 8.7                         | 8.3          |
| Other operating income                | 1.0                       | 2.4          | 0.3                         | 1.0          |
| Net realized investment gain          | 0.6                       | 0.3          | 0.4                         | 0.1          |
| Other-than-temporary impairment loss  |                           | (0.4)        |                             | (0.3)        |
| Total revenue                         | 100.0                     | 100.0        | 100.0                       | 100.0        |
| Loss and loss adjustment expense, net | 53.3                      | 51.5         | 51.5                        | 50.4         |
| Policy acquisition costs, net         | 15.9                      | 15.1         | 16.1                        | 15.5         |
| Other operating expense               | 10.9                      | 11.0         | 10.9                        | 10.6         |
| Interest expense                      | 0.9                       | 0.7          | 0.9                         | 0.6          |
| Earnings before income tax expense    | 19.0                      | 21.7         | 20.6                        | 22.9         |
| Income tax expense                    | 5.8                       | 6.9          | 6.2                         | 7.1          |
| <b>Net earnings</b>                   | <b>13.2%</b>              | <b>14.8%</b> | <b>14.4%</b>                | <b>15.8%</b> |

**Revenue**

Total revenue decreased \$7.4 million in the first six months of 2010, compared to the same period in 2009, due to: 1) the \$25.0 million from the 2009 commutation of the MGIC reinsurance contract, partially offset by 2) higher net earned premium in 2010 and 3) \$8.0 million of revenue in 2010 related to the gain on the commutation of a derivative contract.

Gross written premium, net written premium and net earned premium are detailed below. Growth in written premium occurred primarily in our London market account line of business, directly related to property treaty business that we began to write in late

**Table of Contents**

2009. The increase in net earned premium was primarily due to growth in our directors and officers liability business in 2009 and 2010. There were offsetting increases and decreases in net earned premium in our other lines of business. See the Insurance Company Segment section below for further discussion of the relationship and changes in premium revenue.

|                              | <b>Six months ended June 30,</b> |             | <b>Three months ended June 30,</b> |             |
|------------------------------|----------------------------------|-------------|------------------------------------|-------------|
|                              | <b>2010</b>                      | <b>2009</b> | <b>2010</b>                        | <b>2009</b> |
| <b>Gross written premium</b> | \$1,314,074                      | \$1,283,704 | \$691,578                          | \$681,317   |
| <b>Net written premium</b>   | 1,045,053                        | 1,034,602   | 546,802                            | 543,352     |
| <b>Net earned premium</b>    | 1,015,972                        | 1,004,366   | 506,385                            | 501,978     |

The table below shows the source of our fee and commission income, which decreased 29% year-over-year. The decrease in 2010 primarily related to the sale of our U.K. reinsurance broker and the sale of the operations of our commercial marine agency business, both in 2009, and a \$5.0 million termination payment from the 2009 commutation of the MGIC reinsurance contract.

|                                  | <b>Six months ended June 30,</b> |                  | <b>Three month ended June 30,</b> |                  |
|----------------------------------|----------------------------------|------------------|-----------------------------------|------------------|
|                                  | <b>2010</b>                      | <b>2009</b>      | <b>2010</b>                       | <b>2009</b>      |
| Agencies                         | \$ 28,949                        | \$ 44,033        | \$ 13,888                         | \$ 19,457        |
| Insurance companies              | 11,219                           | 12,393           | 5,287                             | 6,675            |
| <b>Fee and commission income</b> | <b>\$ 40,168</b>                 | <b>\$ 56,426</b> | <b>\$ 19,175</b>                  | <b>\$ 26,132</b> |

The sources of net investment income are detailed below.

|                               | <b>Six months ended June 30,</b> |                  | <b>Three months ended June 30,</b> |                  |
|-------------------------------|----------------------------------|------------------|------------------------------------|------------------|
|                               | <b>2010</b>                      | <b>2009</b>      | <b>2010</b>                        | <b>2009</b>      |
| Fixed income securities       |                                  |                  |                                    |                  |
| Taxable                       | \$ 54,803                        | \$ 52,099        | \$ 27,935                          | \$ 26,994        |
| Exempt from U.S. income taxes | 44,277                           | 40,813           | 22,546                             | 20,480           |
| Total fixed income securities | 99,080                           | 92,912           | 50,481                             | 47,474           |
| Short-term investments        | 360                              | 1,470            | 170                                | 586              |
| Other                         | 2,042                            | 1,051            | 534                                | 1,103            |
| Total investment income       | 101,482                          | 95,433           | 51,185                             | 49,163           |
| Investment expense            | (2,016)                          | (1,804)          | (968)                              | (752)            |
| <b>Net investment income</b>  | <b>\$ 99,466</b>                 | <b>\$ 93,629</b> | <b>\$ 50,217</b>                   | <b>\$ 48,411</b> |

Net investment income increased 6% year-over-year and 4% quarter-over-quarter, primarily due to higher income from fixed income securities, generated from an increased amount of investments. Our fixed income securities portfolio increased 11% from \$4.6 billion at June 30, 2009 to \$5.1 billion at June 30, 2010. The growth in fixed income securities resulted primarily from cash flow from operations and reinvestment of funds that were held in short-term investments at December 31, 2009. Short-term investment income declined in the three and six month periods, due to lower average short-term investment balances and lower short-term market interest rates. Other interest income for the six month periods included \$0.6 million of interest related to a tax refund in 2010, and a \$1.0 million loss on hedge fund investments in 2009, which were liquidated in late 2008.

Other operating income was \$12.0 million in the first half of 2010, compared to \$28.4 million in the first half of 2009 and \$2.1 million in the second quarter of 2010, compared to \$5.5 million in the second quarter of 2009. The first half of 2010 included an \$8.0 million gain related to commuting a derivative contract. The first half of 2009 included \$20.5 million from the commutation of the MGIC reinsurance contract. Period to period comparisons of our other operating income may vary substantially, depending on earnings generated by new transactions or investments, income or loss related to changes in the fair value of certain investments, and gains or losses related to dispositions.

**Table of Contents**

The following table details the components of our other operating income.

|                                   | Six months ended June |           | Three months ended June |          |
|-----------------------------------|-----------------------|-----------|-------------------------|----------|
|                                   | 2010                  | 2009      | 2010                    | 2009     |
| Contract using deposit accounting | \$                    | \$ 20,532 | \$                      | \$       |
| Financial instruments             | 8,379                 | 3,657     | 179                     | 3,294    |
| Strategic investments             | 557                   | 1,855     | 147                     | 1,105    |
| Other                             | 3,057                 | 2,375     | 1,761                   | 1,124    |
| <b>Other operating income</b>     | \$ 11,993             | \$ 28,419 | \$ 2,087                | \$ 5,523 |

**Expenses**

Loss and loss adjustment expense increased year-over-year primarily due to the \$20.6 million of net catastrophic losses incurred in the first quarter of 2010. Our loss ratio for the first six months of 2010 was 61.6% (which included 2.0 percentage points for the catastrophes), compared to 60.5% in the first six months of 2009. The loss ratio was 59.0% and 58.3% in the second quarter of 2010 and 2009, respectively. Policy acquisition costs increased 4% year-over-year because: 1) our 2009 policy acquisition costs were lower due to the effect of a \$3.8 million premium deficiency reserve recorded at December 31, 2008, which reduced the amount of policy acquisition costs recognized throughout 2009 and 2) the higher amount of premium earned in 2010. See the Insurance Company Segment section below for further discussion of the changes in our loss and loss adjustment expense and policy acquisition costs.

Other operating expense, which includes compensation expense, decreased 1% year-over-year and increased 2% quarter-over-quarter. We had 1,893 employees at June 30, 2010 compared to 1,922 a year earlier. In 2009, we sold our U.K. reinsurance broker and the operations of our commercial marine agency business, which primarily accounts for the reduction in other operating expense and the number of employees in 2010. In addition, year-to-date other operating expense for 2010 and 2009 included \$3.0 million and \$9.9 million of expense for costs directly related to the commutations of a derivative contract and the MGIC reinsurance contract, respectively. Currency conversion expense was \$2.7 million and \$1.2 million in the first six months and the second quarter of 2010, respectively, compared to a \$0.2 million and \$0.1 million benefit in the first six months and the second quarter of 2009, respectively.

Other operating expense includes \$7.3 million and \$7.9 million in the first six months of 2010 and 2009, respectively, of stock-based compensation expense, after the effect of the deferral and amortization of policy acquisition costs related to stock-based compensation for our underwriters. In the first half of 2010, we granted \$19.3 million of restricted stock awards and units, with a weighted-average life of 6.5 years. At June 30, 2010, there was approximately \$27.3 million of total unrecognized compensation expense related to unvested options and restricted stock awards and units that is expected to be recognized over a weighted-average period of 4.0 years.

Our effective income tax rate was 30.5% for the first six months of 2010, compared to 31.7% for the first six months of 2009. The lower effective rate in 2010 related to the increased benefit from tax-exempt investment income relative to a lower pretax income base.

At June 30, 2010, total assets were \$9.0 billion and shareholders' equity was \$3.2 billion, compared to \$8.8 billion and \$3.0 billion, respectively, at December 31, 2009. Our book value per share was \$27.78, which increased from \$26.58 at December 31, 2009.

**Segments*****Insurance Company Segment***

Net earnings of our insurance company segment decreased \$11.4 million, or 6%, and \$2.1 million, or 2%, in the first six months and second quarter of 2010, compared to the same periods in 2009. We recognized catastrophe losses in the first quarter of 2010 of \$20.6 million (pretax and net of reinsurance). In addition, the commutation of the MGIC reinsurance contract generated \$20.5 million in insurance company revenue in the first quarter of 2009. These two items more than offset the effect of higher net earned premium and greater investment income recognized in the first six months of 2010, as well as the gain in the first half of 2010 from the commutation of a derivative contract.



**Table of Contents****Premium**

Gross written premium was 2% higher in the first six months and second quarter of 2010, compared to the same periods in 2009, due to the addition of our property treaty business, which we began writing in late 2009, partially offset by reductions in other lines of business due to the soft insurance market. The overall percentage of retained premium, as measured by the percent of net written premium to gross written premium, was 80% and 81% in the first six months of 2010 and 2009, respectively.

The following tables provide premium information by line of business.

|                                 | <b>Gross<br/>written<br/>premium</b> | <b>Net<br/>written<br/>premium</b> | <b>NWP<br/>as % of<br/>GWP</b> | <b>Net<br/>earned<br/>premium</b> |
|---------------------------------|--------------------------------------|------------------------------------|--------------------------------|-----------------------------------|
| Six months ended June 30, 2010  |                                      |                                    |                                |                                   |
| Diversified financial products  |                                      |                                    |                                |                                   |
| Directors and officers          | \$ 219,740                           | \$ 146,699                         | 67 %                           | \$ 183,639                        |
| Errors and omissions            | 113,499                              | 96,478                             | 85                             | 106,691                           |
| Other                           | 32,339                               | 24,225                             | 75                             | 21,364                            |
| U.S. surety and credit          | 117,170                              | 107,559                            | 92                             | 98,620                            |
| International surety and credit | 40,245                               | 36,673                             | 91                             | 35,884                            |
|                                 | 522,993                              | 411,634                            | 79                             | 446,198                           |
| Group life, accident and health |                                      |                                    |                                |                                   |
| Medical stop-loss               | 323,558                              | 323,558                            | 100                            | 323,558                           |
| Other medical                   | 49,356                               | 49,356                             | 100                            | 50,618                            |
| Other                           | 38,010                               | 10,067                             | 26                             | 12,597                            |
|                                 | 410,924                              | 382,981                            | 93                             | 386,773                           |
| Aviation                        | 76,908                               | 53,750                             | 70                             | 58,298                            |
| London market account           |                                      |                                    |                                |                                   |
| Energy                          | 80,322                               | 47,465                             | 59                             | 26,789                            |
| Property treaty                 | 55,095                               | 49,046                             | 89                             | 15,609                            |
| Other                           | 63,610                               | 41,250                             | 65                             | 29,215                            |
|                                 | 199,027                              | 137,761                            | 69                             | 71,613                            |

Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

|                       |              |              |      |              |
|-----------------------|--------------|--------------|------|--------------|
| Other specialty lines |              |              |      |              |
| Public risk           | 34,691       | 23,650       | 68   | 22,926       |
| HCC Lloyd s           | 27,369       | 24,898       | 91   | 19,187       |
| Other                 | 42,130       | 10,347       | 25   | 10,945       |
|                       | 104,190      | 58,895       | 57   | 53,058       |
|                       |              |              |      |              |
| Discontinued lines    | 32           | 32           | nm   | 32           |
|                       |              |              |      |              |
| <b>Totals</b>         | \$ 1,314,074 | \$ 1,045,053 | 80 % | \$ 1,015,972 |

31

---



**Table of Contents**

|                                 | <b>Gross<br/>written<br/>premium</b> | <b>Net<br/>written<br/>premium</b> | <b>NWP<br/>as % of<br/>GWP</b> | <b>Net<br/>earned<br/>premium</b> |
|---------------------------------|--------------------------------------|------------------------------------|--------------------------------|-----------------------------------|
| Six months ended June 30, 2009  |                                      |                                    |                                |                                   |
| Diversified financial products  |                                      |                                    |                                |                                   |
| Directors and officers          | \$ 232,710                           | \$ 167,141                         | 72 %                           | \$ 172,488                        |
| Errors and omissions            | 127,857                              | 111,359                            | 87                             | 118,282                           |
| Other                           | 44,581                               | 35,433                             | 79                             | 20,767                            |
| U.S. surety and credit          | 96,339                               | 91,794                             | 95                             | 89,727                            |
| International surety and credit | 39,575                               | 35,135                             | 89                             | 32,651                            |
|                                 | 541,062                              | 440,862                            | 81                             | 433,915                           |
| Group life, accident and health |                                      |                                    |                                |                                   |
| Medical stop-loss               | 315,844                              | 315,842                            | 100                            | 315,842                           |
| Other medical                   | 63,459                               | 63,459                             | 100                            | 66,229                            |
| Other                           | 46,026                               | 15,370                             | 33                             | 16,100                            |
|                                 | 425,329                              | 394,671                            | 93                             | 398,171                           |
| Aviation                        | 83,751                               | 60,876                             | 73                             | 65,461                            |
| London market account           |                                      |                                    |                                |                                   |
| Energy                          | 77,632                               | 47,735                             | 61                             | 22,439                            |
| Property treaty                 |                                      |                                    |                                |                                   |
| Other                           | 56,589                               | 32,806                             | 58                             | 26,940                            |
|                                 | 134,221                              | 80,541                             | 60                             | 49,379                            |
| Other specialty lines           |                                      |                                    |                                |                                   |
| Public risk                     | 35,877                               | 27,851                             | 78                             | 17,807                            |
| HCC Lloyd's                     | 23,613                               | 18,917                             | 80                             | 20,940                            |
| Other                           | 39,861                               | 10,894                             | 27                             | 18,703                            |
|                                 | 99,351                               | 57,662                             | 58                             | 57,450                            |

|                    |              |              |      |              |
|--------------------|--------------|--------------|------|--------------|
| Discontinued lines | (10)         | (10)         | nm   | (10)         |
| <b>Totals</b>      | \$ 1,283,704 | \$ 1,034,602 | 81 % | \$ 1,004,366 |

32

---

**Table of Contents**

|                                  | <b>Gross<br/>written<br/>premium</b> | <b>Net<br/>written<br/>premium</b> | <b>NWP<br/>as % of<br/>GWP</b> | <b>Net<br/>earned<br/>premium</b> |
|----------------------------------|--------------------------------------|------------------------------------|--------------------------------|-----------------------------------|
| Three months ended June 30, 2010 |                                      |                                    |                                |                                   |
| Diversified financial products   |                                      |                                    |                                |                                   |
| Directors and officers           | \$ 135,572                           | \$ 90,743                          | 67 %                           | \$ 90,721                         |
| Errors and omissions             | 57,151                               | 48,515                             | 85                             | 52,798                            |
| Other                            | 15,927                               | 11,304                             | 71                             | 9,538                             |
| U.S. surety and credit           | 63,149                               | 60,140                             | 95                             | 51,871                            |
| International surety and credit  | 18,940                               | 17,037                             | 90                             | 17,695                            |
|                                  | 290,739                              | 227,739                            | 78                             | 222,623                           |
| Group life, accident and health  |                                      |                                    |                                |                                   |
| Medical stop-loss                | 161,792                              | 161,792                            | 100                            | 161,792                           |
| Other medical                    | 27,038                               | 27,038                             | 100                            | 25,597                            |
| Other                            | 15,712                               | 4,919                              | 31                             | 5,742                             |
|                                  | 204,542                              | 193,749                            | 95                             | 193,131                           |
| Aviation                         | 39,387                               | 27,729                             | 70                             | 29,355                            |
| London market account            |                                      |                                    |                                |                                   |
| Energy                           | 63,740                               | 37,623                             | 59                             | 10,602                            |
| Property treaty                  | 17,465                               | 13,789                             | 79                             | 8,855                             |
| Other                            | 23,860                               | 17,799                             | 75                             | 15,988                            |
|                                  | 105,065                              | 69,211                             | 66                             | 35,445                            |
| Other specialty lines            |                                      |                                    |                                |                                   |
| Public risk                      | 17,979                               | 14,445                             | 80                             | 11,436                            |
| HCC Lloyd's                      | 9,767                                | 8,625                              | 88                             | 9,002                             |
| Other                            | 24,109                               | 5,314                              | 22                             | 5,403                             |
|                                  | 51,855                               | 28,384                             | 55                             | 25,841                            |

|                    |            |            |      |            |
|--------------------|------------|------------|------|------------|
| Discontinued lines | (10)       | (10)       | nm   | (10)       |
| <b>Totals</b>      | \$ 691,578 | \$ 546,802 | 79 % | \$ 506,385 |

**Table of Contents**

|                                  | <b>Gross<br/>written<br/>premium</b> | <b>Net<br/>written<br/>premium</b> | <b>NWP<br/>as % of<br/>GWP</b> | <b>Net<br/>earned<br/>premium</b> |
|----------------------------------|--------------------------------------|------------------------------------|--------------------------------|-----------------------------------|
| Three months ended June 30, 2009 |                                      |                                    |                                |                                   |
| Diversified financial products   |                                      |                                    |                                |                                   |
| Directors and officers           | \$ 138,426                           | \$ 99,674                          | 72 %                           | \$ 89,686                         |
| Errors and omissions             | 65,498                               | 56,707                             | 87                             | 58,877                            |
| Other                            | 18,807                               | 13,601                             | 72                             | 9,791                             |
| U.S. surety and credit           | 52,206                               | 49,392                             | 95                             | 45,235                            |
| International surety and credit  | 21,013                               | 18,125                             | 86                             | 16,242                            |
|                                  | 295,950                              | 237,499                            | 80                             | 219,831                           |
| Group life, accident and health  |                                      |                                    |                                |                                   |
| Medical stop-loss                | 156,358                              | 156,358                            | 100                            | 156,359                           |
| Other medical                    | 31,853                               | 31,853                             | 100                            | 33,176                            |
| Other                            | 20,125                               | 7,404                              | 37                             | 7,548                             |
|                                  | 208,336                              | 195,615                            | 94                             | 197,083                           |
| Aviation                         | 41,799                               | 30,265                             | 72                             | 32,647                            |
| London market account            |                                      |                                    |                                |                                   |
| Energy                           | 62,818                               | 41,558                             | 66                             | 13,204                            |
| Property treaty                  |                                      |                                    |                                |                                   |
| Other                            | 26,654                               | 12,589                             | 47                             | 12,501                            |
|                                  | 89,472                               | 54,147                             | 61                             | 25,705                            |
| Other specialty lines            |                                      |                                    |                                |                                   |
| Public risk                      | 15,943                               | 12,735                             | 80                             | 9,187                             |
| HCC Lloyd's                      | 12,391                               | 9,236                              | 75                             | 10,150                            |
| Other                            | 17,440                               | 3,869                              | 22                             | 7,389                             |
|                                  | 45,774                               | 25,840                             | 56                             | 26,726                            |

|                    |            |            |      |            |
|--------------------|------------|------------|------|------------|
| Discontinued lines | (14 )      | (14 )      | nm   | (14 )      |
| <b>Totals</b>      | \$ 681,317 | \$ 543,352 | 80 % | \$ 501,978 |

nm Not meaningful

The changes in premium volume and retention levels resulted principally from the following factors:

Diversified financial products Gross written premium was higher in 2009 because we wrote more directors and officers liability and errors and omissions liability business due to the perception in the market place at that time about the financial strength of some of our competitors. In addition, pricing on these product lines was lower in 2010. The pricing for credit insurance improved in 2010, and our premium has increased accordingly. Our retention rate was lower in 2010 due to lower quota share retention on our international directors and officers liability business, as well as additional reinsurance on our U.S. business in order to increase gross maximum limits per account. Net earned premium increased in 2010 primarily due to the high volume of directors and officers liability business written in 2009, primarily in the second half of the year.

**Table of Contents**

Group life, accident and health The decrease in premium was due to our discontinuance of the provider excess business in late 2009.

Aviation We wrote less aviation premium in 2010 due to continuing competition for U.S. business. Our international writings were stable due to improved pricing in the international market.

London market account Premium increased primarily due to our new property treaty business, which we started writing in late 2009. On a full year basis, our retention on the property treaty business is expected to approximate 80%.

Other specialty lines Although premium and retention ratios by product changed year-over-year due to changes in the mix of business, total premium and the overall retention rate were essentially flat for our other specialty lines.

**Losses and Loss Adjustment Expenses**

Our gross loss ratio was 64.4% and 61.9% in the first six months of 2010 and 2009, respectively, and 64.3% and 58.8% in the second quarter of 2010 and 2009, respectively. The 2010 year-to-date and second quarter gross loss ratios included 4.7 percentage points and 4.4 percentage points, respectively, for the catastrophe losses that occurred in the first quarter and the Deepwater Horizon rig disaster that occurred in the second quarter.

The table below shows the composition of net incurred loss and loss adjustment expense.

|   | Six months ended June 30,<br>2010 |              | 2009              |              | Three months ended June 30,<br>2010 |              | 2009              |              |  |
|---|-----------------------------------|--------------|-------------------|--------------|-------------------------------------|--------------|-------------------|--------------|--|
|   | Amount                            | Loss ratio   | Amount            | Loss ratio   | Amount                              | Loss ratio   | Amount            | Loss ratio   |  |
| 2010 catastrophes (Redundant)                           | \$ 20,588                         | 2.0%         | \$                | %            | \$                                  | %            | \$                | %            |  |
| adverse reserve development                             | 2,166                             | 0.2          | (11,272)          | (1.1)        | (2,844)                             | (0.6)        | (15,999)          | (3.2)        |  |
| All other net incurred loss and loss adjustment expense | 602,753                           | 59.4         | 619,408           | 61.6         | 301,830                             | 59.6         | 308,569           | 61.5         |  |
| <b>Net incurred loss and loss adjustment expense</b>    | <b>\$ 625,507</b>                 | <b>61.6%</b> | <b>\$ 608,136</b> | <b>60.5%</b> | <b>\$ 298,986</b>                   | <b>59.0%</b> | <b>\$ 292,570</b> | <b>58.3%</b> |  |

Our adverse development for the six months of 2010 primarily resulted from the effect of: 1) a \$3.0 million increase in reserves on our discontinued assumed accident and health line, due to receipt of new claims information and 2) re-estimation of our net claims exposure for products in the life, accident and health line of business, partially offset by reduction of our reserves for the 2005 and 2008 hurricanes. The redundant development in the six months of 2009 primarily resulted from reduction of our loss reserves for: 1) the 2005 hurricanes, 2) the U.K. professional indemnity business for the 2004–2006 underwriting years and 3) our aviation business for the 2001–2006 underwriting years. This redundancy was partially offset by adverse development related to re-estimation of claims exposure for certain products in the life, accident and health line of business. Deficiencies and redundancies in reserves occur as we review our loss reserves with our actuaries, increasing or reducing loss reserves as a result of such reviews and as losses are finally settled or claims exposures change.

We provide directors and officers liability, errors and omissions liability and fiduciary liability coverage for certain financial institutions, which have potential exposure to shareholders lawsuits related to subprime issues. During the second quarter of 2010, there were no new subprime-related claims. We have no material exposure to environmental or asbestos losses.

We believe we have provided for all material net incurred losses as of June 30, 2010.



**Table of Contents**

The following table provides comparative net loss ratios by line of business and major product lines.

|                                       | Six months ended June 30, |                      |                          |                      | Three months ended June 30, |                      |                          |                      |
|---------------------------------------|---------------------------|----------------------|--------------------------|----------------------|-----------------------------|----------------------|--------------------------|----------------------|
|                                       | 2010                      |                      | 2009                     |                      | 2010                        |                      | 2009                     |                      |
|                                       | Net<br>earned<br>premium  | Net<br>loss<br>ratio | Net<br>earned<br>premium | Net<br>loss<br>ratio | Net<br>earned<br>premium    | Net<br>loss<br>ratio | Net<br>earned<br>premium | Net<br>loss<br>ratio |
| Diversified<br>financial products     |                           |                      |                          |                      |                             |                      |                          |                      |
| Directors and<br>officers             | \$ 183,639                | 62.5%                | \$ 172,488               | 62.1%                | \$ 90,721                   | 61.9%                | \$ 89,686                | 63.4%                |
| Errors and<br>omissions               | 106,691                   | 56.6                 | 118,282                  | 49.5                 | 52,798                      | 56.1                 | 58,877                   | 43.8                 |
| Other                                 | 21,364                    | 41.3                 | 20,767                   | 47.7                 | 9,538                       | 50.3                 | 9,791                    | 45.2                 |
| U.S. surety and<br>credit             | 98,620                    | 28.3                 | 89,727                   | 30.9                 | 51,871                      | 29.9                 | 45,235                   | 31.4                 |
| International<br>surety and credit    | 35,884                    | 38.4                 | 32,651                   | 55.4                 | 17,695                      | 32.7                 | 16,242                   | 57.7                 |
|                                       | 446,198                   | 50.6                 | 433,915                  | 51.0                 | 222,623                     | 50.2                 | 219,831                  | 50.3                 |
| Group life,<br>accident and<br>health |                           |                      |                          |                      |                             |                      |                          |                      |
| Medical stop-loss                     | 323,558                   | 73.9                 | 315,842                  | 73.5                 | 161,792                     | 74.0                 | 156,359                  | 74.4                 |
| Other medical                         | 50,618                    | 68.6                 | 66,229                   | 78.7                 | 25,597                      | 60.5                 | 33,176                   | 68.7                 |
| Other                                 | 12,597                    | 58.3                 | 16,100                   | 58.4                 | 5,742                       | 63.3                 | 7,548                    | 59.8                 |
|                                       | 386,773                   | 72.7                 | 398,171                  | 73.8                 | 193,131                     | 71.9                 | 197,083                  | 72.9                 |
| Aviation                              | 58,298                    | 59.3                 | 65,461                   | 57.0                 | 29,355                      | 61.9                 | 32,647                   | 52.7                 |
| London market<br>account              |                           |                      |                          |                      |                             |                      |                          |                      |
| Energy                                | 26,789                    | 36.7                 | 22,439                   | 7.7                  | 10,602                      | (26.1)               | 13,204                   | (7.6)                |
| Property treaty                       | 15,609                    | 103.5                |                          |                      | 8,855                       | 47.5                 |                          |                      |
| Other                                 | 29,215                    | 60.8                 | 26,940                   | 42.6                 | 15,988                      | 44.4                 | 12,501                   | 35.5                 |
|                                       | 71,613                    | 61.1                 | 49,379                   | 26.7                 | 35,445                      | 24.1                 | 25,705                   | 13.4                 |
| Other specialty<br>lines              |                           |                      |                          |                      |                             |                      |                          |                      |
| Public risk                           | 22,926                    | 69.6                 | 17,807                   | 66.4                 | 11,436                      | 69.2                 | 9,187                    | 64.2                 |
| HCC Lloyd's                           | 19,187                    | 62.1                 | 20,940                   | 65.1                 | 9,002                       | 63.2                 | 10,150                   | 62.6                 |
| Other                                 | 10,945                    | 87.6                 | 18,703                   | 91.2                 | 5,403                       | 96.7                 | 7,389                    | 72.6                 |

Edgar Filing: HCC INSURANCE HOLDINGS INC/DE/ - Form 10-Q

|                       |              |       |              |       |            |       |            |       |
|-----------------------|--------------|-------|--------------|-------|------------|-------|------------|-------|
|                       | 53,058       | 70.6  | 57,450       | 74.0  | 25,841     | 72.9  | 26,726     | 65.9  |
| Discontinued lines    | 32           | nm    | (10)         | nm    | (10)       | nm    | (14)       | nm    |
| <b>Totals</b>         | \$ 1,015,972 | 61.6% | \$ 1,004,366 | 60.5% | \$ 506,385 | 59.0% | \$ 501,978 | 58.3% |
| <b>Expense ratio</b>  |              | 26.4  |              | 25.0  |            | 26.6  |            | 25.5  |
| <b>Combined ratio</b> |              | 88.0% |              | 85.5% |            | 85.6% |            | 83.8% |

nm Not meaningful

**Table of Contents**

The changes in net loss ratios between periods resulted principally from the following factors:

*Group life, accident and health* The lower 2010 loss ratios for the other medical products resulted from improvements in our medical excess business.

*Aviation* The 2009 loss ratios included favorable prior year development, which reduced the year-to-date and second quarter loss ratio by 7.6 percentage points and 15.4 percentage points, respectively.

*London market account* The 2010 net loss ratios for all major product lines included the effect of the first quarter catastrophe losses, which increased the year-to-date total London market account loss ratio by 28.7 percentage points. The 2010 and 2009 net loss ratios included redundant reserve development on prior year hurricanes. The redundancies reduced the total London market account loss ratio by 9.5 percentage points and 17.9 percentage points for year-to-date 2010 and 2009, respectively, and 21.5 percentage points and 30.3 percentage points in the second quarter of 2010 and 2009, respectively.

The table below provides a reconciliation of our reserves for loss and loss adjustment expense payable, net of reinsurance ceded, the amount of our paid claims and our net paid loss ratios.

|   | Six months ended June 30, |                     | Three months ended June 30, |                     |
|---|---------------------------|---------------------|-----------------------------|---------------------|
|   | 2010                      | 2009                | 2010                        | 2009                |
| Net reserves for loss and loss adjustment expense payable at beginning of period  | \$ 2,555,840              | \$ 2,416,271        | \$ 2,555,670                | \$ 2,472,475        |
| Net reserve additions from acquired businesses                                    | 8,110                     | 34,922              |                             | 4,713               |
| Foreign currency adjustment   | (47,786)                  | 29,355              | (20,673)                    | 47,627              |
| Incurred loss and loss adjustment expense   | 625,507                   | 608,136             | 298,986                     | 292,570             |
| Loss and loss adjustment expense payments   | (573,354)                 | (525,488)           | (265,666)                   | (254,189)           |
| <b>Net reserves for loss and loss adjustment expense payable at end of period</b> | <b>\$ 2,568,317</b>       | <b>\$ 2,563,196</b> | <b>\$ 2,568,317</b>         | <b>\$ 2,563,196</b> |
| <b>Net paid loss ratio</b>  | <b>56.4%</b>              | <b>52.3%</b>        | <b>52.5%</b>                | <b>50.6%</b>        |

The net paid loss ratio is the percentage of losses paid, net of reinsurance, divided by net earned premium for the period. The net paid loss ratio was higher in the 2010 periods, primarily due to a higher amount of claims payments for our directors and officers liability, credit and medical stop-loss businesses than in the same prior year periods.

**Policy Acquisition Costs**

Policy acquisition costs, which are reported net of the related portion of commissions on reinsurance ceded, as a percentage of net earned premium increased to 18.3% in the first six months of 2010 from 17.8% in the first six months of 2009, principally due to the effect of a \$3.8 million premium deficiency reserve recorded at December 31, 2008, which reduced the amount of policy acquisition costs recognized throughout 2009. The GAAP expense ratio of 26.4% in the first six months of 2010 exceeded the expense ratio of 25.0% in the first six months of 2009, primarily due to higher expenses related to our international business and higher currency conversion expense. In addition, the expense ratio for the first six months of 2009 included a benefit from reversing a provision for uncollectible reinsurance.

**Agency Segment**

Revenue from our agency segment was \$67.1 million in the first six months of 2010, compared to \$94.1 million in the first six months of 2009. The reduction was expected due to the sale of our U.K. reinsurance broker and the sale of the

operations of our commercial marine agency business in 2009. In addition, we had \$5.0 million of revenue in the first six months of 2009 from a termination payment from the commutation of the MGIC reinsurance contract. As a result of this lower revenue, the segment had a net loss of \$1.4 million in the first six months of 2010, compared to net earnings of \$8.5 million in the same period of 2009. The segment had \$3.0 million of net earnings in the second quarter of 2010. We expect the agency segment will generate net earnings for full year 2010 due to the seasonality of business written by our largest agency.

**Table of Contents**

***Other Operations Segment***

Revenue and net earnings from our other operations segment were \$3.9 million and \$1.4 million, respectively, in the first six months of 2010 compared to \$5.2 million and \$2.2 million, respectively, in the first six months of 2009. Results of this segment may vary substantially period to period depending on our investment in or disposition of strategic investments.

**Liquidity and Capital Resources**

Credit market disruptions in recent years have resulted in a tightening of available sources of credit and significant liquidity concerns for many companies. We believe we have sufficient sources of liquidity at a reasonable cost at the present time, based on the following:

We held \$560.3 million of cash and liquid short-term investments at June 30, 2010.

Our available for sale bond portfolio had a fair value of \$4.9 billion at June 30, 2010, compared to \$4.5 billion at December 31, 2009, and has an average rating of AA+. We intend to hold these securities until their maturity, but we would be able to sell securities to generate cash if the need arises. Should we sell certain securities in the portfolio before their maturity, we cannot be assured that we would recoup the full reported fair value of the securities sold at the time of sale.

Our insurance companies have sufficient resources to pay potential claims in 2010. As of December 31, 2009, we projected that during 2010 they will pay \$1.2 billion of claims and collect approximately \$314.7 million of reinsurance recoveries on claims incurred as of year-end 2009. At December 31, 2009, our insurance companies had approximately \$1.2 billion of cash, short-term investments, maturing bonds, and principal payments from mortgage-backed and asset-backed securities that will be available to pay these expected claims in 2010. As of June 30, 2010, there has been no significant change in our expectations of our subsidiaries ability to pay claims.

Our debt consists of \$300.0 million principal amount of unsecured 6.30% Senior Notes due November 15, 2019. Our debt to total capital ratio was 8.5% at June 30, 2010 and 9.0% at December 31, 2009.

We have a committed \$575.0 million Revolving Loan Facility at a rate of 30-day LIBOR plus 25 basis points that matures December 19, 2011. Letters of credit issued on behalf of certain of our subsidiaries reduce available borrowing capacity under the facility. At June 30, 2010, we had \$553.4 million of unused capacity, which we can draw against at any time at our request. The facility agreement contains two restrictive financial covenants, with which we were in compliance at June 30, 2010.

During 2010, there was no significant change in our Standby Letter of Credit Facility used to guarantee our performance in our Lloyd's of London syndicates.

Our domestic insurance subsidiaries have the ability to pay \$217.8 million in dividends in 2010 to our holding company without obtaining special permission from state regulatory authorities. Our underwriting agencies have no restrictions on the amount of dividends that can be paid to our holding company. The holding company can utilize these dividends for any purpose, including to pay down debt, pay dividends to shareholders, fund acquisitions, purchase common stock and pay operating expenses. Cash flow available to the holding company in 2010 is expected to be more than ample to cover the holding company's required cash disbursements.

We have a Universal Shelf registration statement that provides for the issuance of an aggregate of \$1.0 billion of securities, of which we have \$700.0 million of remaining capacity. These securities may be debt securities, equity securities, or a combination thereof. The shelf registration statement provides us the means to access the debt and equity markets relatively quickly, if we are satisfied with the current pricing in the financial market.

***Cash Flow***

We receive substantial cash from premiums, reinsurance recoverables, outward commutations, fee and commission income, proceeds

**Table of Contents**

from sales and redemptions of investments and investment income. Our principal cash outflows are for the payment of claims and loss adjustment expenses, premium payments to reinsurers, inward commutations, purchases of investments, debt service, policy acquisition costs, operating expenses, taxes, dividends and common stock purchases. Cash provided by operating activities can fluctuate due to timing differences in the collection of premiums and reinsurance recoverables and the payment of losses and premium and reinsurance balances payable and the completion of commutations.

We generated cash from operations of \$139.3 million and \$262.2 million in the first six months of 2010 and 2009, respectively. The components of our net operating cash flows are summarized in the following table.

|   | <b>Six months ended June 30,</b> |                   |
|---|----------------------------------|-------------------|
|   | <b>2010</b>                      | <b>2009</b>       |
| Net earnings  | \$ 154,734                       | \$ 174,755        |
| Change in premium, claims and other receivables, net of reinsurance, other payables and restricted cash | (67,355)                         | (38,200)          |
| Change in unearned premium, net   | 27,911                           | 41,547            |
| Change in loss and loss adjustment expense payable, net of reinsurance recoverables                     | 39,357                           | 73,839            |
| (Gain) loss on investments  | (7,329)                          | 1,924             |
| Other, net  | (7,992)                          | 8,311             |
| <b>Cash provided by operating activities</b>  | <b>\$ 139,326</b>                | <b>\$ 262,176</b> |

We had \$47.9 million of higher claims payments in 2010, compared to 2009, which was the largest contributor to the reduction in cash provided by operating activities. Timing differences in the collection of premium and payment of reinsurance balances payable reduced our cash provided by operating activities in 2010 compared to 2009. In 2010, we received \$8.3 million of cash to commute a derivative contract and in 2009, we received \$25.0 million to commute the MGIC reinsurance contract. Cash provided by operating activities can fluctuate due to timing differences in the collection of premium and reinsurance recoverables and the payment of claims and premium and reinsurance balances payable.

We maintain a substantial level of cash and liquid short-term investments to meet anticipated payment obligations. During January 2010, we paid the final \$64.5 million due to previous holders of our 1.3% Convertible Notes that were submitted for conversion in December 2009 using cash held as of December 31, 2009. Our combined cash and short-term investments totaled \$560.3 million at June 30, 2010.

**Table of Contents****Investments**

At June 30, 2010, we had \$5.6 billion of total investments, an increase of \$95.9 million from December 31, 2009. This table summarizes our investments by type, substantially all of which are reported at fair value, at June 30, 2010 and December 31, 2009.

|  | <b>June 30, 2010</b> |             | <b>December 31, 2009</b> |             |
|--|----------------------|-------------|--------------------------|-------------|
|  | <b>Amount</b>        | <b>%</b>    | <b>Amount</b>            | <b>%</b>    |
| U.S. government and government agency securities                                   | \$ 370,896           | 7%          | \$ 328,535               | 6%          |
| Fixed income securities of states, municipalities and political subdivisions       | 1,090,158            | 20          | 1,059,426                | 19          |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 1,392,736            | 25          | 1,146,334                | 21          |
| Corporate fixed income securities  | 751,172              | 14          | 693,915                  | 13          |
| Residential mortgage-backed securities   | 1,064,299            | 19          | 944,182                  | 17          |
| Commercial mortgage-backed securities  | 147,902              | 2           | 146,217                  | 3           |
| Asset-backed securities  | 11,546               |             | 14,365                   |             |
| Foreign government securities  | 246,846              | 4           | 307,891                  | 6           |
| Short-term investments   | 476,176              | 9           | 810,673                  | 15          |
| Other investments  | 433                  |             | 4,691                    |             |
| <b>Total investments</b>   | <b>\$ 5,552,164</b>  | <b>100%</b> | <b>\$ 5,456,229</b>      | <b>100%</b> |

This table shows the average amount of investments, net income earned, related yields and duration, and average rating of our fixed income securities.

|  | <b>Six months ended June 30,</b> |             | <b>Three months ended June 30,</b> |             |
|--|----------------------------------|-------------|------------------------------------|-------------|
|  | <b>2010</b>                      | <b>2009</b> | <b>2010</b>                        | <b>2009</b> |
| Average investments, at cost                         | \$5,324,304                      | \$4,968,017 | \$5,338,843                        | \$5,057,271 |
| Net investment income *                              | 99,466                           | 93,629      | 50,217                             | 48,411      |
| Average short-term yield *                           | 0.1%                             | 0.5%        | 0.1%                               | 0.4%        |
| Average long-term yield *                            | 4.1%                             | 4.2%        | 4.1%                               | 4.3%        |
| Average long-term tax equivalent yield *             | 5.0%                             | 5.1%        | 5.0%                               | 5.2%        |
| Average combined tax equivalent yield *              | 4.5%                             | 4.5%        | 4.5%                               | 4.6%        |
| Weighted-average life of fixed income securities     | 6.5 years                        | 6.7 years   |                                    |             |
| Weighted-average duration of fixed income securities | 4.8 years                        | 5.0 years   |                                    |             |
| Weighted-average combined duration                   | 4.4 years                        | 4.4 years   |                                    |             |
| Average rating of fixed income securities            | AA+                              | AA+         |                                    |             |

\* Excluding realized and unrealized gains and losses.



**Table of Contents**

This table summarizes our investments in fixed income securities by their rating category at June 30, 2010.

|                                      | Available for sale<br>at fair value |             | Held to maturity<br>at amortized cost |             |
|--------------------------------------|-------------------------------------|-------------|---------------------------------------|-------------|
|                                      | Amount                              | %           | Amount                                | %           |
| AAA                                  | \$ 2,354,670                        | 48%         | \$ 83,006                             | 48%         |
| AA                                   | 1,803,499                           | 37          | 26,200                                | 15          |
| A                                    | 607,169                             | 12          | 61,851                                | 36          |
| BBB                                  | 99,325                              | 2           | 1,292                                 | 1           |
| BB and below                         | 38,543                              | 1           |                                       |             |
| <b>Total fixed income securities</b> | <b>\$ 4,903,206</b>                 | <b>100%</b> | <b>\$ 172,349</b>                     | <b>100%</b> |

The overall rating of our municipal bonds (consisting of our fixed income securities of states, municipalities and political subdivisions and our special purpose revenue bonds of states, municipalities and political subdivisions) was AA+ at June 30, 2010. Our portfolio of special purpose revenue bonds at June 30, 2010 and December 31, 2009 included \$111.9 million and \$138.7 million, respectively, of pre-refunded bonds that are supported by U.S. government debt obligations. The remaining special purpose bonds are secured by revenue sources specific to each security, such as water, sewer and utility fees; highway tolls; airport usage fees; property, sales and fuel taxes; college tuition and services fees; electric utilities and lease income. The table below summarizes our percentage holdings of special purpose revenue bonds by revenue source.

|                 | June 30,<br>2010 | December<br>31,<br>2009 |
|-----------------|------------------|-------------------------|
| Water and sewer | 26%              | 27%                     |
| Education       | 16               | 14                      |
| Transportation  | 13               | 13                      |
| Special tax     | 10               | 11                      |
| Pre-refunded    | 9                | 13                      |
| Leasing         | 8                | 8                       |
| Electric        | 8                | 7                       |
| Other           | 10               | 7                       |
| <b>Total</b>    | <b>100%</b>      | <b>100%</b>             |

Many of our special purpose revenue bonds are insured by mono-line insurance companies or supported by credit enhancement programs of various states and municipalities. We view bond insurance as credit enhancement and not credit substitution. We base our investment decision on the strength of the issuer. A credit review is performed on each issuer and on the sustainability of the revenue source before we acquire a special purpose revenue bond and periodically, on an ongoing basis, thereafter. The underlying average credit rating of our special purpose revenue bond issuers, excluding any bond insurance, was AA+ at June 30, 2010. Although recent economic conditions in the United States may reduce the source of revenue to support certain of these securities, the majority are supported by revenue from essential sources, such as water and sewer, education and transportation fees, which we believe generate a stable source of revenue.

At June 30, 2010, we held a corporate bond portfolio with a carrying value of \$751.2 million, an overall rating of A+, and a weighted-average life of approximately 3.2 years.

At June 30, 2010, we also held a portfolio of residential mortgage-backed securities (MBSs) and collateralized mortgage-obligations (CMOs) with a fair value of \$1.1 billion. Within our residential MBS/CMO portfolio, \$1.0 billion of securities, or 95%, were issued by the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which are backed by the U.S. government. Of the remaining \$52.9 million of residential mortgage-backed securities, 91% were collateralized by prime mortgages.

**Table of Contents**

At June 30, 2010, we held a commercial MBS securities portfolio with a fair value of \$147.9 million, an average rating of AA+, an average loan-to-value ratio of 72%, and a weighted-average life of approximately 4.5 years. We owned no collateralized debt obligations (CDOs) or collateralized loan obligations (CLOs), and we have never been counterparty to any credit default swap transactions.

This table indicates the expected maturity distribution of our fixed income securities at June 30, 2010.

|                                      | <b>Mortgage-backed<br/>and</b>                      |             |   |             |   |             |  |             |
|--------------------------------------|---|-------------|---|-------------|---|-------------|--|-------------|
|                                      | <b>Available for sale<br/>at<br/>amortized cost</b> |             | <b>asset-backed at<br/>amortized cost</b> |             | <b>Held to maturity<br/>at<br/>amortized cost</b> |             | <b>Total fixed income<br/>securities</b> |             |
|                                      | <b>Amount</b>                                       | <b>%</b>    | <b>Amount</b>                             | <b>%</b>    | <b>Amount</b>                                     | <b>%</b>    | <b>Amount</b>                            | <b>%</b>    |
| One year or less                     | \$ 268,234  | 8%          | \$ 146,347                                | 12%         | \$ 23,758   | 14%         | \$ 438,339                               | 9%          |
| One year to five years               | 1,070,303   | 30          | 881,634                                   | 76          | 137,148   | 80          | 2,089,085                                | 43          |
| Five years to ten years              | 836,824   | 24          | 128,918                                   | 11          | 11,443  | 6           | 977,185                                  | 20          |
| Ten years to fifteen years           | 726,382   | 21          | 5,726                                     | 1           |   |             | 732,108                                  | 15          |
| More than fifteen years              | 613,895   | 17          |   |             |   |             | 613,895                                  | 13          |
| <b>Total fixed income securities</b> | <b>\$ 3,515,638</b>                                 | <b>100%</b> | <b>\$ 1,162,625</b>                       | <b>100%</b> | <b>\$ 172,349</b>                                 | <b>100%</b> | <b>\$ 4,850,612</b>                      | <b>100%</b> |

A security has an impairment loss when its fair value is less than its cost or amortized cost at the balance sheet date. The gross unrealized losses of the individual securities within our available for sale fixed income securities portfolios were \$7.5 million at June 30, 2010, compared to \$18.9 million at December 31, 2009. We evaluate the securities in our fixed income securities portfolio for possible other-than-temporary impairment losses at each quarter end. For a description of the accounting policies and procedures that we use to determine our other-than-temporary impairment losses, see Footnote 3, Investments, in the notes to these condensed consolidated financial statements and Critical Accounting Policies Other-than-temporary Impairments in Investments in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2009. We recognized no other-than-temporary impairment credit losses in 2010, compared to \$5.0 million and \$1.8 million in the first six months and second quarter of 2009, respectively.

At June 30, 2010, the net unrealized gain on our available for sale fixed income securities portfolio was \$224.9 million, compared to \$156.3 million at December 31, 2009. The change in the net unrealized gain, net of the related income tax effect, is recorded in other comprehensive income and fluctuates with changes in market interest rates. Our general policy has been to hold our fixed income securities, most of which are primarily classified as available for sale, through periods of fluctuating interest rates and to not realize significant gains or losses from their sale. We recognized \$6.8 million and \$4.0 million of pretax net realized investment gains in the first six months of 2010 and 2009, respectively.

**Accounting Guidance in 2010**

A new accounting standard, originally issued as SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, became effective January 1, 2010. The guidance, which was incorporated into Accounting Standards Codification (ASC) Topic 810, *Consolidation*, changes various aspects of accounting for and disclosures of interests in variable interest entities. Our adoption of this guidance as of January 1, 2010 had no material impact on our condensed consolidated financial statements.

Effective January 1, 2010, we adopted Accounting Standards Update (ASU) No. 2010-06, which incorporated changes in disclosure requirements into ASC Topic 820, *Fair Value Measurements and Disclosures*. Where applicable, we have included the additional required disclosures in the notes to our condensed consolidated financial statements. A new accounting standard, ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, was issued in July 2010. The new guidance expands disclosures related to financing receivables, including the nature of credit risk in financing receivables, how that risk is analyzed in determining the related allowance for credit losses, and changes to the allowance during the reporting period. We will provide the additional required disclosures in our Form 10-K for the year ended December 31, 2010.

**Table of Contents**

**Critical Accounting Policies**

We have made no changes in the identification or methods of application of our critical accounting policies from the information provided in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies, in our Annual Report on Form 10-K for the year ended December 31, 2009.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There have been no material changes in market risk from the information provided in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the year ended December 31, 2009.

**Item 4. Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Act)) that are designed to ensure that required information is recorded, processed, summarized and reported within the required timeframe, as specified in rules set forth by the Securities and Exchange Commission. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), to allow timely decisions regarding required disclosures.

Our management, with the participation of our CEO and CFO, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2010. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of June 30, 2010.

(b) Changes in Internal Control over Financial Reporting

During the second quarter of 2010, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****Part II Other Information****Item 1. Legal Proceedings**

We are a party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of any such matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

**Item 1A. Risk Factors**

There have been no material changes in the risk factors described in our Annual Report on Form 10-K for the year ended December 31, 2009.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On June 20, 2008, our Board of Directors approved the purchase of up to \$100.0 million of our common stock. On May 27, 2010, our Board of Directors approved a new authorization for \$300.0 million and cancelled the \$0.7 million remaining under the original authorization. The new share purchase plan authorizes purchases to be made in the open market or in privately negotiated transactions from time-to-time in compliance with applicable rules and regulations, including Rule 10b-18 under the Securities Exchange Act of 1934, as amended. Purchases under the plan will be subject to market and business conditions, as well as the level of cash generated from our operations, cash required for acquisitions, debt covenant compliance, trading price of the stock being at or below book value and other relevant factors. The purchase plan does not obligate us to purchase any particular number of shares, and may be suspended or discontinued at any time at our discretion. As of June 30, 2010, we had paid \$100.0 million to purchase 4,722,911 shares of our common stock in the open market pursuant to these purchase programs.

During the second quarter of 2010, we purchased our common stock, as follows:

| Period                    |                | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Approximate dollar value of shares that may yet be purchased under the plans or programs |
|---------------------------|----------------|----------------------------------|------------------------------|--|--|
| <b>2008 Authorization</b> |                |                                  |                              |  |  |
| April 1                   | April 30, 2010 |                                  | \$                           |  | \$ 1,201,217   |
| May 1                     | May 31, 2010   | 19,650                           | 24.00                        | 19,650   |  |
| <b>2010 Authorization</b> |                |                                  |                              |  |  |
| May 1                     | May 31, 2010   |                                  | \$                           |  | \$ 300,000,000   |
| June 1                    | June 30, 2010  | 30,500                           | 24.63                        | 30,500   | 299,248,840  |

**Item 6. Exhibits**

## a. Exhibits

- 3.1 Restated Certificate of Incorporation and Certificate of Amendment of Certificate of Incorporation of HCC Insurance Holdings, Inc., filed with the Delaware Secretary of State on July 23, 1996 and May 21, 1998, respectively (incorporated by reference to Exhibit 4.1 to our Registration Statement of Form S-8 (Registration No. 333-61687) filed August 17, 1998).



**Table of Contents**

|      |  |
|------|--|
| 3.2  | Amended and Restated Bylaws of HCC Insurance Holdings, Inc., as amended (incorporated by reference to Exhibit 3.1 to our Form 8-K filed April 3, 2008).  |
| 10.1 | First Amendment to Employment Agreement effective April 19, 2010, between HCC Insurance Holdings, Inc. and William T. Whamond (incorporated by reference to Exhibit 10.01 to our Form 8-K filed April 19, 2010).*  |
| 10.2 | Employment Agreement dated May 27, 2010, between HCC Insurance Holdings, Inc. and Brad T. Irick.*  |
| 12   | Statement of Ratio of Earnings to Fixed Charges.   |
| 31.1 | Certification by Chief Executive Officer.  |
| 31.2 | Certification by Chief Financial Officer.  |
| 32   | Certification with Respect to Quarterly Report.  |
| 101  | The following financial statements from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, formatted in XBRL: (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Earnings, (iii) Condensed Consolidated Statement of Changes in Shareholders Equity, (iv) Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements.** |

\* Executive Compensation Plans and Arrangements

\*\* The XBRL related information in Exhibit 101 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or



other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HCC Insurance Holdings, Inc.

(Registrant)

August 6, 2010

/s/ John N. Molbeck, Jr.

(Date)

John N. Molbeck, Jr., President  
and Chief Executive Officer

August 6, 2010

/s/ Pamela J. Penny

(Date)

Pamela J. Penny, Executive Vice  
President  
and Chief Accounting Officer

46