

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

August 08, 2011

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, 2011.

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 definitions 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 29, 2011, there were approximately 110.0 million shares of common stock outstanding.

HCC Insurance Holdings, Inc. and Subsidiaries
Table of Contents

	Page
Part I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
<u>Consolidated Balance Sheets June 30, 2011 and December 31, 2010</u>	5
<u>Consolidated Statements of Earnings Six months and three months ended June 30, 2011 and 2010</u>	6
<u>Consolidated Statement of Changes in Shareholders Equity Six months ended June 30, 2011</u>	7
<u>Consolidated Statements of Cash Flows Six months ended June 30, 2011 and 2010</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	42
<u>Item 4. Controls and Procedures</u>	42
Part II. OTHER INFORMATION	
<u>Item 1. Legal Proceedings</u>	43
<u>Item 1A. Risk Factors</u>	43
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	43
<u>Item 3. Defaults Upon Senior Securities</u>	43
<u>Item 4. [Removed and Reserved]</u>	43
<u>Item 5. Other Information</u>	43
<u>Item 6. Exhibits</u>	44
<u>Signatures</u>	45
<u>EX-12</u>	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</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 catastrophe 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 past and future potential credit market downturns, including the potential future ratings downgrade and/or impairment or perceived impairment of debt securities of sovereign issuers, including the United States of America,

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, including defaults, 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, 2010.

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
Consolidated Balance Sheets
(unaudited, in thousands except per share data)

	June 30, 2011	December 31, 2010
ASSETS		
Investments		
Fixed income securities available for sale, at fair value (amortized cost: 2011 \$5,240,718; 2010 \$4,864,806)	\$ 5,434,761	\$ 4,999,440
Fixed income securities held to maturity, at amortized cost (fair value: 2011 \$176,352; 2010 \$195,811)	173,993	193,668
Short-term investments, at cost, which approximates fair value	194,507	488,002
Other investments	31,942	5,985
Total investments	5,835,203	5,687,095
Cash	87,242	97,857
Restricted cash	230,532	148,547
Premium, claims and other receivables	716,463	635,867
Reinsurance recoverables	1,103,855	1,006,855
Ceded unearned premium	242,599	278,663
Ceded life and annuity benefits	57,604	58,409
Deferred policy acquisition costs	229,248	212,786
Goodwill	842,056	821,648
Other assets	130,324	116,355
Total assets	\$ 9,475,126	\$ 9,064,082
LIABILITIES		
Loss and loss adjustment expense payable	\$ 3,655,944	\$ 3,471,858
Life and annuity policy benefits	57,604	58,409
Reinsurance, premium and claims payable	327,180	345,730
Unearned premium	1,110,638	1,045,877
Deferred ceding commissions	67,015	72,565
Notes payable	393,714	298,637
Accounts payable and accrued liabilities	593,337	474,574
Total liabilities	6,205,432	5,767,650
SHAREHOLDERS EQUITY		
Common stock, \$1.00 par value; 250,000 shares authorized (shares issued: 2011 122,594 and 2010 120,942; outstanding: 2011 110,274 and 2010	122,594	120,942

114,968)		
Additional paid-in capital	995,053	954,332
Retained earnings	2,341,736	2,257,895
Accumulated other comprehensive income	145,887	97,186
Treasury stock, at cost (shares: 2011 12,320 and 2010 5,974)	(335,576)	(133,923)
Total shareholders equity	3,269,694	3,296,432
Total liabilities and shareholders equity	\$ 9,475,126	\$ 9,064,082

See Notes to Consolidated Financial Statements.

5

Table of Contents

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

	Six months ended June 30,		Three months ended June	
	2011	2010	30,	2010
			2011	2010
REVENUE				
Net earned premium	\$ 1,032,731	\$ 1,015,972	\$ 524,251	\$ 506,385
Net investment income	104,017	99,466	52,422	50,217
Other operating income	14,796	27,147	7,475	9,206
Net realized investment gain	495	6,840	1,054	2,315
Other-than-temporary impairment credit losses	(3,479)		(350)	
Total revenue	1,148,560	1,149,425	584,852	568,123
EXPENSE				
Loss and loss adjustment expense, net	681,868	625,507	334,282	298,986
Policy acquisition costs, net	167,861	161,330	84,483	81,632
Other operating expense	128,060	129,183	63,748	62,515
Interest expense	10,987	10,627	5,434	5,237
Total expense	988,776	926,647	487,947	448,370
Earnings before income tax expense	159,784	222,778	96,905	119,753
Income tax expense	43,316	68,044	27,427	36,373
Net earnings	\$ 116,468	\$ 154,734	\$ 69,478	\$ 83,380
Earnings per common share				
Basic	\$ 1.02	\$ 1.34	\$ 0.61	\$ 0.72
Diluted	\$ 1.02	\$ 1.34	\$ 0.61	\$ 0.72

See Notes to Consolidated Financial Statements.

Table of Contents

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

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Treasury stock	Total shareholders equity
Balance at December 31, 2010	\$ 120,942	\$ 954,332	\$ 2,257,895	\$ 97,186	\$ (133,923)	\$ 3,296,432
Comprehensive income						
Net earnings			116,468			116,468
Other comprehensive income						
Change in net unrealized gain on investments, net of tax				42,017		42,017
Other, net of tax				6,684		6,684
Total other comprehensive income						48,701
Comprehensive income						
						165,169
Issuance of 1,411 shares for exercise of options, including tax effect	1,411	33,825				35,236
Purchase of 6,346 common shares					(201,653)	(201,653)
Stock-based compensation	241	6,896				7,137
Cash dividends declared, \$0.29 per share			(32,627)			(32,627)
Balance at June 30, 2011	\$ 122,594	\$ 995,053	\$ 2,341,736	\$ 145,887	\$ (335,576)	\$ 3,269,694

See Notes to Consolidated Financial Statements.

Table of Contents

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

	Six months ended June 30,	
	2011	2010
Operating activities		
Net earnings	\$ 116,468	\$ 154,734
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Change in premium, claims and other receivables	(103,245)	(79,735)
Change in reinsurance recoverables	(84,728)	(60,013)
Change in ceded unearned premium	36,870	(4,630)
Change in loss and loss adjustment expense payable	147,870	99,370
Change in unearned premium	63,015	32,541
Change in reinsurance, premium and claims payable, excluding restricted cash	(30,413)	12,380
Change in accounts payable and accrued liabilities	(19,426)	(15,389)
Stock-based compensation expense	7,137	6,937
Depreciation and amortization expense	8,769	8,249
(Gain) loss on investments	2,984	(7,329)
Other, net	(23,517)	(7,789)
Cash provided by operating activities	121,784	139,326
Investing activities		
Sales of available for sale fixed income securities	246,331	133,856
Maturity or call of available for sale fixed income securities	285,637	260,053
Maturity or call of held to maturity fixed income securities	24,932	25,253
Cost of available for sale fixed income securities acquired	(835,368)	(703,341)
Cost of held to maturity fixed income securities acquired		(96,383)
Cost of other investments acquired	(27,784)	
Change in short-term investments	292,365	320,927
Payments for purchase of businesses, net of cash received	(1,892)	(36,348)
Proceeds from sale of subsidiaries and other investments	944	19,855
Other, net	(11,886)	(9,405)
Cash used by investing activities	(26,721)	(85,533)
Financing activities		
Advances on line of credit	95,000	
Payments on convertible notes		(64,472)
Sale of common stock	35,236	10,143
Purchase of common stock	(200,302)	(472)
Dividends paid	(33,305)	(30,983)
Other, net	(2,307)	(13,307)
Cash used by financing activities	(105,678)	(99,091)

Net decrease in cash	(10,615)	(45,298)
Cash at beginning of year	97,857	129,460
Cash at end of period	\$ 87,242	\$ 84,162

See Notes to Consolidated Financial Statements.

8

Table of Contents

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

(1) General Information

HCC Insurance Holdings, Inc. (HCC) and its subsidiaries (collectively we, us or our) include domestic and foreign property and casualty and life insurance companies and underwriting agencies with offices in the United States, the United Kingdom, Spain and Ireland. We underwrite a variety of non-correlated specialty insurance products in more than 180 countries, including property and casualty, accident and health, surety, credit and aviation product lines. We market our products through a network of independent agents and brokers, producers, managing general agents and directly to customers.

Basis of Presentation

Our unaudited 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 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 consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2010. The consolidated balance sheet at December 31, 2010 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 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 2010 consolidated financial statements to conform to the 2011 presentation. None of our reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

Recently Issued Accounting Guidance

A new accounting standard clarifies the definition of acquisition costs incurred by an insurance company and limits capitalization to such costs directly related to renewing or acquiring new insurance contracts. All costs incurred for unsuccessful marketing or underwriting efforts, along with indirect costs, are to be expensed as incurred. We plan to adopt this guidance on January 1, 2012. We are currently assessing the impact it will have on our consolidated financial statements.

In May 2011, a new accounting pronouncement was issued that will provide a consistent definition of fair value and ensure that fair value measurements and required disclosures are similar between GAAP and International Financial Reporting Standards. The new guidance also expands required disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. We will apply the new guidance prospectively beginning January 1, 2012. We do not expect adoption of the new guidance to have a material impact on our consolidated financial position, results of operations or cash flows.

A new accounting pronouncement was issued in June 2011 that will change the disclosure of comprehensive income. The new guidance permits entities to present total comprehensive income, net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The current option of reporting other comprehensive income and its components in the statement of changes in shareholders' equity will be eliminated. This guidance is effective on January 1, 2012 and must be applied retrospectively. The consolidated financial statements included in our 2010 Form 10-K comply with the new guidance; however, our interim consolidated financial statements have been prepared using the disclosure option that is being eliminated. While the format of our interim consolidated financial statements will change beginning in the first quarter of 2012, this change will not impact our consolidated financial position, results of operations or cash flows.

(2) Fair Value Measurements

We carry 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:

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

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.

9

Table of Contents

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

Our Level 1 investments consist of U.S. Treasuries and equity securities traded in an active exchange market. We use unadjusted quoted prices for identical instruments to measure fair value.

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. 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 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. No markets for our investments were judged to be inactive as of June 30, 2011 or December 31, 2010. Based on these procedures, we did not adjust the prices or quotes provided by our independent pricing services or third party investment manager as of June 30, 2011 or December 31, 2010.

Our Level 3 securities include certain fixed income securities and an insurance contract, classified in other assets, that we account for as a derivative. In the first quarter of 2010, we terminated our interest in a similar insurance contract and recognized an \$8.0 million gain. We determine fair value of our Level 3 securities based on internally developed models that use assumptions or other data that are not readily observable from objective sources.

We exclude from our fair value disclosures our held to maturity investment portfolio measured at amortized cost. The following tables present our assets that were measured at fair value at June 30, 2011 and December 31, 2010. No liabilities were measured at fair value at either balance sheet date.

	Level 1	Level 2	Level 3	Total
<u>June 30, 2011</u>				
Fixed income securities available for sale				
U.S. government and government agency securities	\$ 209,016	\$ 154,339	\$	\$ 363,355
Fixed income securities of states, municipalities and political subdivisions		1,047,341		1,047,341
Special purpose revenue bonds of states, municipalities and political subdivisions		1,630,380		1,630,380
Corporate fixed income securities		706,037	156	706,193
Residential mortgage-backed securities		1,149,598		1,149,598
Commercial mortgage-backed securities		235,732		235,732
Asset-backed securities		39,650	1,088	40,738
Foreign government securities		261,424		261,424
Total fixed income securities available for sale	209,016	5,224,501	1,244	5,434,761
Other investments	31,742			31,742
Other assets			1,242	1,242
Total assets measured at fair value	\$ 240,758	\$ 5,224,501	\$ 2,486	\$ 5,467,745

Table of Contents

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

	Level 1	Level 2	Level 3	Total
<u>December 31, 2010</u>				
Fixed income securities available for sale				
U.S. government and government agency securities	\$ 148,217	\$ 176,050	\$	\$ 324,267
Fixed income securities of states, municipalities and political subdivisions		1,082,057		1,082,057
Special purpose revenue bonds of states, municipalities and political subdivisions		1,628,059		1,628,059
Corporate fixed income securities		570,152	242	570,394
Residential mortgage-backed securities		995,108		995,108
Commercial mortgage-backed securities		145,228		145,228
Asset-backed securities		11,370	1,196	12,566
Foreign government securities		241,761		241,761
Total fixed income securities available for sale	148,217	4,849,785	1,438	4,999,440
Other investments	5,575			5,575
Other assets			857	857
Total assets measured at fair value	\$ 153,792	\$ 4,849,785	\$ 2,295	\$ 5,005,872

The following tables present the changes in fair value of our Level 3 assets.

	2011			2010		
	Fixed income securities	Other assets	Total	Fixed income securities	Other assets	Total
Balance at beginning of year	\$ 1,438	\$ 857	\$ 2,295	\$ 4,262	\$ 432	\$ 4,694
Settlements					(8,342)	(8,342)
Sales	(144)		(144)	(100)		(100)
Gains and (losses) unrealized	(11)	263	252	62	(141)	(79)
Gains and (losses) realized	(2)		(2)		8,342	8,342
Balance at March 31	1,281	1,120	2,401	4,224	291	4,515
Sales	(55)		(55)	(395)		(395)
Gains and (losses) unrealized	18	122	140	144	179	323
Balance at June 30	\$ 1,244	\$ 1,242	\$ 2,486	\$ 3,973	\$ 470	\$ 4,443

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. There were no transfers between Level 1, Level 2 or Level 3 in the first six months of 2011 or 2010.

Table of Contents

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

(3) Investments

Substantially all of our fixed income securities are investment grade. The cost or amortized cost, gross unrealized gain or loss, and fair value of our fixed income securities were as follows:

	Cost or amortized cost	Available for sale		
		Gross unrealized gain	Gross unrealized loss	Fair value
<u>June 30, 2011</u>				
U.S. government and government agency securities	\$ 353,530	\$ 9,837	\$ (12)	\$ 363,355
Fixed income securities of states, municipalities and political subdivisions	997,673	52,388	(2,720)	1,047,341
Special purpose revenue bonds of states, municipalities and political subdivisions	1,580,332	55,512	(5,464)	1,630,380
Corporate fixed income securities	681,433	27,179	(2,419)	706,193
Residential mortgage-backed securities	1,106,984	46,547	(3,933)	1,149,598
Commercial mortgage-backed securities	227,224	9,919	(1,411)	235,732
Asset-backed securities	40,672	108	(42)	40,738
Foreign government securities	252,870	8,927	(373)	261,424
Total fixed income securities available for sale	\$ 5,240,718	\$ 210,417	\$ (16,374)	\$ 5,434,761
<u>December 31, 2010</u>				
U.S. government and government agency securities	\$ 315,339	\$ 9,097	\$ (169)	\$ 324,267
Fixed income securities of states, municipalities and political subdivisions	1,050,969	38,825	(7,737)	1,082,057
Special purpose revenue bonds of states, municipalities and political subdivisions	1,614,554	34,764	(21,259)	1,628,059
Corporate fixed income securities	545,883	26,436	(1,925)	570,394
Residential mortgage-backed securities	958,404	40,949	(4,245)	995,108
Commercial mortgage-backed securities	136,746	8,518	(36)	145,228
Asset-backed securities	12,563	78	(75)	12,566
Foreign government securities	230,348	11,537	(124)	241,761
Total fixed income securities available for sale	\$ 4,864,806	\$ 170,204	\$ (35,570)	\$ 4,999,440

Table of Contents

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

	Cost or amortized cost	Held to maturity		Fair value
		Gross unrealized gain	Gross unrealized loss	
<u>June 30, 2011</u>				
U.S. government securities	\$ 6,997	\$ 157	\$	\$ 7,154
Corporate fixed income securities	116,937	1,710	(391)	118,256
Foreign government securities	50,059	883		50,942
Total fixed income securities held to maturity	\$ 173,993	\$ 2,750	\$ (391)	\$ 176,352

December 31, 2010

U.S. government securities	\$ 12,993	\$ 264	\$	\$ 13,257
Corporate fixed income securities	113,296	1,205	(277)	114,224
Foreign government securities	67,379	995	(44)	68,330
Total fixed income securities held to maturity	\$ 193,668	\$ 2,464	\$ (321)	\$ 195,811

All fixed income securities were income producing in 2011. 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.

	Less than 12 months		12 months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
<u>June 30, 2011</u>						
U.S. government and government agency securities	\$ 12,816	\$ (12)	\$	\$	\$ 12,816	\$ (12)
Fixed income securities of states, municipalities and political subdivisions	101,478	(2,656)	1,585	(64)	103,063	(2,720)
Special purpose revenue bonds of states, municipalities and political subdivisions	313,517	(5,225)	8,425	(239)	321,942	(5,464)
Corporate fixed income securities	140,455	(2,419)			140,455	(2,419)
Residential mortgage-backed securities	163,755	(3,273)	10,761	(660)	174,516	(3,933)
Commercial mortgage-backed securities	97,766	(1,411)			97,766	(1,411)
Asset-backed securities	13,042	(42)			13,042	(42)

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

Foreign government securities	23,023	(373)			23,023	(373)
Total	\$ 865,852	\$ (15,411)	\$ 20,771	\$ (963)	\$ 886,623	\$ (16,374)

Table of Contents

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

	Less than 12 months Unrealized		12 months or more Unrealized		Total Unrealized	
	Fair value	losses	Fair value	losses	Fair value	losses
<u>December 31, 2010</u>						
U.S. government and government agency securities	\$ 20,976	\$ (169)	\$	\$	\$ 20,976	\$ (169)
Fixed income securities of states, municipalities and political subdivisions	228,228	(7,621)	2,279	(116)	230,507	(7,737)
Special purpose revenue bonds of states, municipalities and political subdivisions	689,190	(21,156)	6,344	(103)	695,534	(21,259)
Corporate fixed income securities	66,029	(1,925)			66,029	(1,925)
Residential mortgage-backed securities	123,782	(3,081)	22,152	(1,164)	145,934	(4,245)
Commercial mortgage-backed securities			3,084	(36)	3,084	(36)
Asset-backed securities	9,174	(75)			9,174	(75)
Foreign government securities	10,699	(124)			10,699	(124)
Total	\$ 1,148,078	\$ (34,151)	\$ 33,859	\$ (1,419)	\$ 1,181,937	\$ (35,570)

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. Our reviews cover all impaired securities where the loss exceeds \$0.5 million and the loss either exceeds 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. Any non-credit portion of the other-than-temporary impairment loss is recognized in shareholders' equity. Our other-than-temporary impairment losses were as follows:

	Six months ended June 30,		Three months ended June 30,	
	2011	2010	2011	2010
Total other-than-temporary impairment loss	\$ (4,677)	\$	\$ (1,548)	\$
Portion recognized in other comprehensive income	1,198		1,198	
Net other-than-temporary impairment loss recognized in earnings	\$ (3,479)	\$	\$ (350)	\$

We have recognized credit losses on certain impaired fixed income securities, for which each security also had an impairment loss recorded in other comprehensive income. The rollforward of these credit losses was as follows:

	Six months ended June		Three months ended June	
	30,		30,	
	2011	2010	2011	2010
Balance at beginning of period	\$ 4,273	\$ 3,848	\$ 6,685	\$ 3,848
Credit losses recognized in earnings				
Securities previously impaired	1,597		350	
Securities previously not impaired	1,882			
Securities sold	(3,905)		(3,188)	
Balance at June 30	\$ 3,847	\$ 3,848	\$ 3,847	\$ 3,848

We had \$0.9 million of after-tax other-than-temporary impairment losses, related to mortgage-backed securities, included in accumulated other comprehensive income within shareholders' equity at June 30, 2011. This amount includes the after-tax unrealized

Table of Contents

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

gains and losses on these impaired securities resulting from changes in their fair value subsequent to their initial other-than-temporary impairment measurement dates.

We do not consider the \$16.4 million of gross unrealized losses in our fixed income securities portfolio at June 30, 2011 to be other-than-temporary impairments because: 1) we received substantially all contractual interest and principal payments on these securities as of June 30, 2011, 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, 2011, 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 was 4.9 years at June 30, 2011.

	Available for sale		Held to maturity	
	Cost or amortized cost	Fair value	Amortized cost	Fair value
Due in 1 year or less	\$ 266,293	\$ 270,110	\$ 54,730	\$ 55,227
Due after 1 year through 5 years	1,134,360	1,184,638	118,389	120,204
Due after 5 years through 10 years	1,018,126	1,072,105	874	921
Due after 10 years through 15 years	732,546	757,012		
Due after 15 years	714,513	724,828		
Securities with fixed maturities	3,865,838	4,008,693	173,993	176,352
Mortgage-backed and asset-backed securities	1,374,880	1,426,068		
Total fixed income securities	\$ 5,240,718	\$ 5,434,761	\$ 173,993	\$ 176,352

The sources of net investment income were as follows:

	Six months ended June		Three months ended June	
	30, 2011	2010	30, 2011	2010
Fixed income securities	\$ 104,045	\$ 99,080	\$ 52,039	\$ 50,481
Short-term investments	321	360	165	170
Other	2,030	2,042	1,388	534
Total investment income	106,396	101,482	53,592	51,185
Investment expense	(2,379)	(2,016)	(1,170)	(968)
Net investment income	\$ 104,017	\$ 99,466	\$ 52,422	\$ 50,217

Table of Contents

HCC Insurance Holdings, Inc. and Subsidiaries
Notes to 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 credit losses, were as follows:

	Six months ended June		Three months ended June	
	30,		30,	
	2011	2010	2011	2010
Fixed income securities				
Gains	\$ 4,315	\$ 7,593	\$ 4,099	\$ 2,692
Losses	(3,814)	(599)	(3,035)	(376)
Net fixed income securities	\$ 501	\$ 6,994	\$ 1,064	\$ 2,316
Other investments				
Gains	\$ 4	\$ 2	\$	\$
Losses	(10)	(156)	(10)	(1)
Net other investments	\$ (6)	\$ (154)	\$ (10)	\$ (1)
Total				
Gains	\$ 4,319	\$ 7,595	\$ 4,099	\$ 2,692
Losses	(3,824)	(755)	(3,045)	(377)
Net realized investment gain	\$ 495	\$ 6,840	\$ 1,054	\$ 2,315

(4) Goodwill

The goodwill balances by reportable segment and the changes in goodwill are shown in the table below.

	U.S. Property & Casualty	Professional Liability	Accident & Health	U.S. Surety & Credit	International	Total
Balance at beginning of year	\$ 223,000	\$ 249,820	\$ 144,128	\$ 79,700	\$ 125,000	\$ 821,648
Earnout and other		20,408				20,408
Balance at June 30, 2011	\$ 223,000	\$ 270,228	\$ 144,128	\$ 79,700	\$ 125,000	\$ 842,056

We conducted our 2011 goodwill impairment test as of June 30, 2011, 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.

We acquired HCC Global Financial Products (HCC Global), which underwrites our U.S. and International directors and officers liability business, in 2002. The purchase agreement, as amended, includes a contingency for future earnout payments. The earnout is based on HCC Global's pretax earnings from the acquisition date through September 30, 2007, with no maximum amount due to the former owners. When conditions specified under the purchase agreement are met, we record a net amount owed to or due from the former owners based on our estimate, at that point in time, of how claims will ultimately be settled. This net amount will fluctuate in the future, and the

ultimate total net earnout payments cannot be finally determined until all claims are settled or paid. In March 2011, certain amendments were made to the purchase agreement, which resulted in an adjustment to our estimate of the ultimate amounts to be settled under the agreement. As a result, we increased goodwill by \$20.0 million as of March 31, 2011.

Table of Contents

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

(5) 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 tables present the effect of such reinsurance transactions on our premium, loss and loss adjustment expense and policy acquisition costs.

	Six months ended June 30,		Three months ended June 30,	
	2011	2010	2011	2010
Direct written premium	\$ 1,169,442	\$ 1,131,637	\$ 661,301	\$ 622,445
Reinsurance assumed	221,848	182,437	80,781	69,133
Reinsurance ceded	(242,533)	(269,021)	(132,209)	(144,776)
Net written premium	\$ 1,148,757	\$ 1,045,053	\$ 609,873	\$ 546,802
Direct earned premium	\$ 1,153,511	\$ 1,139,036	\$ 578,703	\$ 567,074
Reinsurance assumed	158,494	141,148	79,113	71,908
Reinsurance ceded	(279,274)	(264,212)	(133,565)	(132,597)
Net earned premium	\$ 1,032,731	\$ 1,015,972	\$ 524,251	\$ 506,385
Direct loss and loss adjustment expense	\$ 786,652	\$ 718,869	\$ 343,898	\$ 357,918
Reinsurance assumed	142,205	105,789	68,298	52,954
Reinsurance ceded	(246,989)	(199,151)	(77,914)	(111,886)
Net loss and loss adjustment expense	\$ 681,868	\$ 625,507	\$ 334,282	\$ 298,986
Policy acquisition costs	\$ 223,847	\$ 218,958	\$ 112,489	\$ 109,853
Ceding commissions	(55,986)	(57,628)	(28,006)	(28,221)
Net policy acquisition costs	\$ 167,861	\$ 161,330	\$ 84,483	\$ 81,632

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

	June 30,	December
	2011	31,
		2010
Reinsurance recoverable on paid losses	\$ 63,103	\$ 75,262
Reinsurance recoverable on outstanding losses	487,294	452,882
Reinsurance recoverable on incurred but not reported losses	555,705	481,204
Reserve for uncollectible reinsurance	(2,247)	(2,493)

Total reinsurance recoverables	\$ 1,103,855	\$ 1,006,855
---------------------------------------	--------------	--------------

Table of Contents

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

At each quarter end, we review our financial exposure to the reinsurance market based on our individual reinsurance recoverable balances as of the prior quarter-end. We take actions to collect outstanding balances or to mitigate our exposure to possible loss, including offsetting past due amounts against letters of credit and other payables. There was no material change in recoverables on paid losses that were outstanding for over 90 days as of June 30, 2011 compared to December 31, 2010. We have a reserve for potentially uncollectible amounts as follows:

	Six months ended June 30,	
	2011	2010
Balance at beginning of year	\$ 2,493	\$ 2,945
Provision expense (recovery)	(246)	
Balance at June 30	\$ 2,247	\$ 2,945

If we collect cash from or resolve a dispute with the reinsurer, we reduce the allowance account. While we believe the reserve is adequate based on information currently available, market conditions may change or additional information might be obtained that may require us to change the reserve in the future.

Reinsurers not authorized by the respective states of domicile of our U.S. domiciled insurance companies are required to collateralize reinsurance obligations due to us. The table below shows the amounts of letters of credit and cash deposits held by us as collateral, plus other credits available for potential offset at June 30, 2011 and December 31, 2010.

	June 30,	December
	2011	31,
		2010
Payables to reinsurers	\$ 266,374	\$ 243,990
Letters of credit	137,859	145,914
Cash deposits	92,996	81,966
Total credits	\$ 497,229	\$ 471,870

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

	June 30,	December
	2011	31,
		2010
Loss and loss adjustment expense payable	\$ 3,655,944	\$ 3,471,858
Reinsurance recoverable on outstanding losses	(487,294)	(452,882)
Reinsurance recoverable on incurred but not reported losses	(555,705)	(481,204)
Net reserves	\$ 2,612,945	\$ 2,537,772
Unearned premium	\$ 1,110,638	\$ 1,045,877
Ceded unearned premium	(242,599)	(278,663)
Net unearned premium	\$ 868,039	\$ 767,214

Deferred policy acquisition costs	\$ 229,248	\$ 212,786
Deferred ceding commissions	(67,015)	(72,565)
Net deferred policy acquisition costs	\$ 162,233	\$ 140,221

Table of Contents

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

(6) Notes Payable

Notes payable were as follows:

	June 30, 2011	December 31, 2010
6.30% Senior Notes	\$ 298,714	\$ 298,637
\$600.0 million Revolving Loan Facility	95,000	
Total notes payable	\$ 393,714	\$ 298,637

On March 8, 2011, we entered into a new agreement for a four-year \$600.0 million Revolving Loan Facility (Facility). The Facility replaced our \$575.0 million Revolving Loan Facility, which was due to expire on December 19, 2011. The Facility allows us to borrow up to the maximum allowed on a revolving basis until the Facility expires on March 8, 2015. The borrowing rate is LIBOR plus 137.5 basis points, subject to increase or decrease based on changes in our debt rating. The contractual interest rate on borrowings under the Facility at June 30, 2011 was 1.61%. In addition, we pay a commitment fee of 20 basis points. Letters of credit issued under the Facility further reduced our available borrowing capacity on the remaining Facility to \$492.1 million at June 30, 2011. The Facility contains restrictive financial covenants that require HCC to maintain a minimum consolidated net worth (excluding accumulated other comprehensive income) and a leverage ratio of less than or equal to 35%.

We were in compliance with debt covenants related to our Senior Notes, Revolving Loan Facility, and Standby Letter of Credit Facility at June 30, 2011.

(7) Earnings Per Share

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

	Six months ended June 30,		Three months ended June 30,	
	2011	2010	2011	2010
Net earnings	\$ 116,468	\$ 154,734	\$ 69,478	\$ 83,380
Less: net earnings attributable to unvested restricted stock awards and restricted stock units	(1,601)	(1,679)	(1,003)	(927)
Net earnings available to common stock	\$ 114,867	\$ 153,055	\$ 68,475	\$ 82,453
Weighted-average common shares outstanding	112,569	113,805	111,389	113,935
Dilutive effect of outstanding options (determined using treasury stock method)	375	322	368	253
Weighted-average common shares and potential common shares outstanding	112,944	114,127	111,757	114,188
Anti-dilutive stock options not included in treasury stock method computation	917	4,392	424	4,680

Table of Contents

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

(8) Stock-based Compensation

In 2011, we granted the following shares of common stock, restricted stock awards, restricted stock units and 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 awards, restricted stock units and stock options will be expensed over the vesting period.

	Number of shares	Weighted-average grant date fair value	Aggregate fair value	Vesting period
Common stock	28	\$ 32.54	\$ 920	3-5
Restricted stock awards	289	31.22	9,023	years
Restricted stock units	65	30.25	1,952	4 years
Stock options	179	7.36	1,317	1-5 years

(9) Segments

We report HCC's results in six operating segments, each of which reports to an HCC executive who is responsible for the segment results. Each of our five insurance-related segments bears risk for insurance coverage written within its portfolio of insurance products. Each segment generates income from premium written by our underwriting agencies, through third party agents and brokers, or on a direct basis. Fee and commission income earned by our agencies from third party insurance companies is included in segment revenue. Each segment incurs insurance losses, acquisition costs and other administrative expenses related to our insurance companies and underwriting agencies. We monitor and assess each segment's pretax results based on underwriting profit, gross and net written premium, and its combined ratio, consisting of the net loss ratio and expense ratio.

Included in the portfolio of products for each underwriting segment are the following key products:

U.S. Property & Casualty – aviation, small account errors and omissions liability, public risk, employment practices liability, title, residual value, disability, contingency, kidnap and ransom, difference in conditions, occupational accident and brown water marine written in the United States.

Professional Liability – directors and officers (D&O) liability, large account errors and omissions liability, fiduciary liability, fidelity, bankers' blanket bonds and, for some D&O policyholders, employment practices liability written in the United States and internationally.

Accident & Health – medical stop-loss, short-term domestic and international medical, HMO reinsurance and medical excess written in the United States.

U.S. Surety & Credit – contract surety bonds, commercial surety bonds, and bail bonds written in the United States and credit insurance managed in the United States.

International – energy, property treaty, liability, surety, credit, property (direct and facultative), ocean marine, accident and health and other smaller product lines written outside the United States.

The Investing segment includes our total investment portfolio, as well as all investment income, investment related expenses, realized investment gains and losses, and other-than-temporary impairment credit losses on investments. All investment activity is reported as revenue, consistent with our consolidated presentation.

In addition to our segments, we include a Corporate & Other category to reconcile segment results to consolidated totals. The Corporate & Other category includes corporate operating expenses not allocable to the segments, interest expense on long-term debt, and underwriting results of our Exited Lines. Our Exited Lines include these six product lines that we no longer write and do not

Table of Contents

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

expect to write in the future: 1) accident and health business managed by our underwriting agency, LDG Reinsurance, 2) workers compensation, 3) provider excess, 4) Spanish medical malpractice, 5) U.K. motor and 6) film completion bonds.

All prior period information included in this Form 10-Q has been adjusted to present our segment disclosures and information on a consistent basis with our new segment reporting structure, which we adopted in the third quarter of 2010.

The following tables present information by business segment.

	U.S. Property Professional Accident & Casualty Liability Health		U.S. Surety & Credit International Investing		Corporate & Other Consolidated			
Six months ended June 30, 2011								
Net earned premium	\$ 159,175	\$ 203,174	\$ 400,657	\$ 101,403	\$ 168,164	\$	\$ 158	\$ 1,032,731
Other revenue	9,666	249	2,194	701	1,902	101,033	84	115,829
Segment revenue	168,841	203,423	402,851	102,104	170,066	101,033	242	1,148,560
Loss and LAE	92,428	138,015	291,605	29,687	130,393		(260)	681,868
Other expense	55,575	34,032	61,995	55,252	64,020		36,034	306,908
Segment expense	148,003	172,047	353,600	84,939	194,413		35,774	988,776
Segment pretax earnings (loss)	\$ 20,838	\$ 31,376	\$ 49,251	\$ 17,165	\$ (24,347)	\$ 101,033	\$ (35,532)	\$ 159,784
Six months ended June 30, 2010								
Net earned premium	\$ 173,625	\$ 218,153	\$ 374,487	\$ 98,620	\$ 149,932	\$	\$ 1,155	\$ 1,015,972
Other revenue	19,095	438	1,717	328	4,711	106,306	858	133,453
Segment revenue	192,720	218,591	376,204	98,948	154,643	106,306	2,013	1,149,425
Loss and LAE	102,801	132,942	273,569	27,861	84,374		3,960	625,507
Other expense	54,601	38,305	59,059	53,692	59,905		35,578	301,140
Segment expense	157,402	171,247	332,628	81,553	144,279		39,538	926,647
Segment pretax earnings (loss)	\$ 35,318	\$ 47,344	\$ 43,576	\$ 17,395	\$ 10,364	\$ 106,306	\$ (37,525)	\$ 222,778

Table of Contents

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

Three months ended June 30, 2011	U.S. Property & Casualty	U.S. Professional Liability	Accident & Health	U.S. Surety & Credit	International	Investing	Corporate & Other	Consolidated
Net earned premium	\$ 78,921	\$ 102,424	\$ 202,117	\$ 50,039	\$ 90,717	\$ 33	\$ 524,251	
Other revenue	4,787	48	1,178	455	894	53,126	113	60,601
Segment revenue	83,708	102,472	203,295	50,494	91,611	53,126	146	584,852
Loss and LAE	44,944	71,752	146,747	14,648	56,221		(30)	334,282
Other expense	27,169	16,928	31,577	26,997	32,355		18,639	153,665
Segment expense	72,113	88,680	178,324	41,645	88,576		18,609	487,947
Segment pretax earnings (loss)	\$ 11,595	\$ 13,792	\$ 24,971	\$ 8,849	\$ 3,035	\$ 53,126	\$(18,463)	\$ 96,905
Three months ended June 30, 2010								
Net earned premium	\$ 84,695	\$ 108,001	\$ 187,703	\$ 51,871	\$ 73,765	\$ 350	\$ 506,385	
Other revenue	6,204	107	867	205	1,666	52,532	157	61,738
Segment revenue	90,899	108,108	188,570	52,076	75,431	52,532	507	568,123
Loss and LAE	50,989	65,342	135,349	15,487	28,769		3,050	298,986
Other expense	23,734	18,767	30,323	26,836	30,745		18,979	149,384
Segment expense	74,723	84,109	165,672	42,323	59,514		22,029	448,370
Segment pretax earnings (loss)	\$ 16,176	\$ 23,999	\$ 22,898	\$ 9,753	\$ 15,917	\$ 52,532	\$(21,522)	\$ 119,753

Catastrophe losses reduced the International segment's pretax earnings by \$72.3 million and \$22.8 million in the first six months and second quarter of 2011, respectively, and \$20.6 million in the first six months of 2010.

(10) Commitments and Contingencies**Catastrophe Exposure**

We have exposure to catastrophe losses caused by natural perils (such as hurricanes, earthquakes, floods, tsunamis and tornados), as well as from man-made events (such as terrorist attacks). The incidence, timing and severity of catastrophe 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 2011, we recognized gross losses of \$120.3 million from catastrophic events in Japan, New Zealand and the United States. After reinsurance and reinstatement premium, our pretax loss was \$73.3 million. In 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.

Table of Contents

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

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, 2011, we have recorded a liability of \$9.5 million and have provided a \$3.0 million escrow account and \$5.2 million of letters of credit to cover our obligations or anticipated payments under these indemnifications.

(11) Supplemental Information

Supplemental information was as follows:

	Six months ended June 30,		Three months ended June 30,	
	2011	2010	2011	2010
Income taxes paid	\$ 57,607	\$ 66,215	\$ 38,501	\$ 53,365
Interest paid	12,152	9,563	9,866	9,341
Proceeds from sales of available for sale fixed income securities	246,331	133,856	197,399	66,167
Comprehensive income	165,169	182,751	119,888	114,814
	23			

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 Consolidated Financial Statements and the related Notes as of December 31, 2010 and June 30, 2011.

Overview

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain and Ireland, transacting business in approximately 180 countries. Our shares trade on the New York Stock Exchange and closed at \$30.13 on July 29, 2011, resulting in market capitalization of \$3.3 billion.

We underwrite a variety of relatively non-correlated specialty insurance products, including property and casualty, accident and health, surety, credit and aviation product lines. We market our insurance products through a network of independent agents and brokers, managing general agents and directly to consumers. In addition, we assume insurance written by other insurance companies. We manage our businesses through five underwriting segments and our Investing segment. Our underwriting segments are U.S. Property & Casualty, Professional Liability, Accident & Health, U.S. Surety & Credit and International.

Our business philosophy is to maximize underwriting profit while managing risk in order to preserve shareholders equity, grow book value and maximize earnings. We concentrate our insurance writings in selected specialty insurance lines of business in which we believe we can achieve meaningful underwriting profit. We also rely on our experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to limit or reduce risk. Our business plan is shaped by our underlying business philosophy. As a result, our primary objective is to increase net earnings and grow book value, rather than to grow our market share or our gross written premium. Our major domestic and international insurance companies have financial strength ratings of AA (Very Strong) from Standard & Poor's Corporation, A+ (Superior) from A.M. Best Company, Inc., AA (Very Strong) from Fitch Ratings and A1 (Good Security) from Moody's Investors Service, Inc.

Key facts about our consolidated group as of and for the six months and quarter ended June 30, 2011 were as follows:

Our common shares closed at \$31.50 per share.

We had consolidated shareholders' equity of \$3.3 billion, with a book value per share of \$29.65.

We generated year-to-date net earnings of \$116.5 million, or \$1.02 per diluted share. Our second quarter earnings were \$69.5 million, or \$0.61 per diluted share.

We produced revenue of \$1.1 billion and \$584.9 million in the first six months and second quarter, respectively. In the first six months, 90% of revenue related to net earned premium and 9% related to net investment income.

In the first six months, we recognized gross losses of \$120.3 million and net losses, after reinsurance and reinstatement premium, of \$73.3 million from catastrophes in Japan, New Zealand and the United States, mainly in our International segment. The second quarter included net catastrophe losses of \$21.9 million.

Our year-to-date net loss ratio, including the 2011 catastrophe losses, was 66.0% and our combined ratio was 91.9%. The catastrophe losses increased the net loss ratio by 6.6 percentage points and the combined ratio by 6.9 percentage points.

In the second quarter, we borrowed \$95.0 million against our new four-year \$600.0 million Revolving Loan Facility to fund share repurchases.

We purchased \$201.7 million, or 6.3 million shares, of our common stock at an average cost of \$31.78 per share in the first six months of 2011.

We declared dividends of \$0.29 per share and paid \$33.3 million of dividends in the first six months of 2011.

Table of Contents

Comparisons in the following sections refer to the first six months of 2011 compared to the same period of 2010, unless otherwise noted. Amounts in tables are in thousands, except for earnings per share, percentages, ratios and number of employees.

Results of Operations

Our results and key metrics for the six months and quarter ended June 30, 2011 and 2010 were as follows:

	Six months ended June 30,		Three months ended June 30,	
	2011	2010	2011	2010
Net earnings	\$ 116,468	\$ 154,734	\$ 69,478	\$ 83,380
Earnings per diluted share	\$ 1.02	\$ 1.34	\$ 0.61	\$ 0.72
Net loss ratio	66.0%	61.6%	63.8%	59.0%
Expense ratio	25.9	25.5	25.4	25.3
Combined ratio	91.9%	87.1%	89.2%	84.3%

Our 2011 and 2010 results include the impact of world-wide catastrophic events. We experienced catastrophe losses primarily from the Japan earthquake and tsunami, the New Zealand earthquakes and the United States tornados in the first and second quarters of 2011, and from the Chile earthquake in the first quarter of 2010. We reinsure a portion of our exposure to such catastrophic events, although we incur some additional cost for reinstatement premium to continue our reinsurance coverage for future loss events. The following table summarizes our catastrophe losses, as well as the impact on our net earnings and key metrics in 2011 and 2010:

	Six months ended June 30,		Three months ended June 30,		
	2011	2010	2011	2010	
Gross losses	\$ 120,259	\$ 31,900	\$ 15,059	\$	
Net losses, after reinsurance and reinstatement premium	\$ 73,328	\$ 20,588	\$ 21,863	\$	
Impact of net catastrophe losses on:					
Net earnings per diluted share	\$ (0.42)	\$ (0.12)	\$ (0.13)	\$	
Net loss ratio (percentage points)	6.6%	2.1%	3.9%		%
Combined ratio (percentage points)	6.9%	2.1%	4.1%		%

Our second quarter 2011 catastrophe losses included \$(3.9) million gross and \$7.1 million net related to revised estimates of our exposures to the first quarter 2011 catastrophes, including the reversal of an expected Japan event cancellation loss of \$20.0 million gross and \$2.0 million net that did not materialize. The majority of our catastrophe losses were incurred in our International segment.

In our Professional Liability segment, private equity companies are included amongst the policyholders we insure in our diversified financial products line of business. Among the claims reported by these policyholders, primarily related to the 2006 underwriting year, are claims based on allegations of violations of U.S. anti-trust laws, in what is known as Club Deal litigation. This litigation has not been settled and defense costs covered under these policies continue at amounts higher than previously estimated. Accordingly, our loss estimates related to these claims increased by \$20.5 million gross and \$10.8 million net in the second quarter of 2011. These losses increased our net loss ratio by 1.0 percentage point in the first six months and 2.1 percentage points in the second quarter of 2011.

Revenue

Total revenue decreased \$0.9 million in the first six months of 2011, compared to the same period in 2010, primarily due to lower other operating income and net realized investment gains, offset by higher net earned premium and net investment income.

Table of Contents

Gross written premium, net written premium and net earned premium are detailed below by segment.

	Six months ended June 30,		Three months ended June 30,	
	2011	2010	2011	2010
U.S. Property & Casualty	\$ 265,511	\$ 269,129	\$ 135,961	\$ 131,507
Professional Liability	262,272	269,516	161,152	161,791
Accident & Health	397,823	373,408	201,523	189,230
U.S. Surety & Credit	113,953	117,170	60,182	63,149
International	351,581	282,778	183,233	145,436
Exited Lines	150	2,073	31	465
Total gross written premium	\$ 1,391,290	\$ 1,314,074	\$ 742,082	\$ 691,578
U.S. Property & Casualty	\$ 180,436	\$ 163,467	\$ 93,714	\$ 83,221
Professional Liability	190,648	178,825	116,857	107,951
Accident & Health	397,500	373,219	201,395	189,136
U.S. Surety & Credit	105,101	107,559	55,394	60,140
International	274,922	221,119	142,482	106,091
Exited Lines	150	864	31	263
Total net written premium	\$ 1,148,757	\$ 1,045,053	\$ 609,873	\$ 546,802
U.S. Property & Casualty	\$ 159,175	\$ 173,625	\$ 78,921	\$ 84,695
Professional Liability	203,174	218,153	102,424	108,001
Accident & Health	400,657	374,487	202,117	187,703
U.S. Surety & Credit	101,403	98,620	50,039	51,871
International	168,164	149,932	90,717	73,765
Exited Lines	158	1,155	33	350
Total net earned premium	\$ 1,032,731	\$ 1,015,972	\$ 524,251	\$ 506,385

Related to the 2011 catastrophe losses, we recorded a net \$11.6 million of reinstatement premium (\$12.7 million ceded net of \$1.1 million assumed) for continued reinsurance coverage, which reduced the International segment's 2011 net written and net earned premium. Growth in written premium occurred primarily in the International segment, directly related to property treaty business that we began to write in late 2009, and in the Accident & Health segment related to our medical stop-loss product. See the Segment Operations section below for further discussion of the relationship and changes in premium revenue within each segment.

Net investment income, which is included in our Investing segment, increased 5% year-over-year primarily due to higher income from fixed income securities, generated from an increased amount of investments. Our fixed income securities portfolio increased 11% from \$5.1 billion at June 30, 2010 to \$5.6 billion at June 30, 2011. The growth in fixed income securities resulted primarily from reinvestment of funds that were held in short-term investments and cash flow from operations.

Table of Contents

The sources of net investment income are detailed below.

	Six months ended June		Three months ended June	
	30,		30,	
	2011	2010	2011	2010
Fixed income securities				
Taxable	\$ 54,219	\$ 54,803	\$ 27,124	\$ 27,935
Exempt from U.S. income taxes	49,826	44,277	24,915	22,546
Total fixed income securities	104,045	99,080	52,039	50,481
Short-term investments	321	360	165	170
Other	2,030	2,042	1,388	534
Total investment income	106,396	101,482	53,592	51,185
Investment expense	(2,379)	(2,016)	(1,170)	(968)
Net investment income	\$ 104,017	\$ 99,466	\$ 52,422	\$ 50,217

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

	Six months ended June		Three months ended June	
	30,		30,	
	2011	2010	2011	2010
Fee and commission income	\$ 11,267	\$ 15,154	\$ 5,528	\$ 7,119
Financial instruments	385	8,379	122	179
Other	3,144	3,614	1,825	1,908
Other operating income	\$ 14,796	\$ 27,147	\$ 7,475	\$ 9,206

Our fee and commission income in 2010 included deferred revenue from a subsidiary sold in late 2009. The financial instruments line relates to derivative contracts denominated in British pound sterling and includes the effect of foreign currency fluctuations compared to the U.S. dollar. In the first quarter of 2010, we terminated our interest in a long-term mortgage impairment insurance contract that had been accounted for as a derivative financial instrument and recognized a \$5.0 million pretax gain. We received £5.6 million (\$8.3 million) of cash, which was included in other operating income, and incurred related expenses of \$3.0 million, which were included in other operating expense. The gain was included in our U.S. Property & Casualty segment's 2010 results.

Loss and Loss Adjustment Expense

Our gross loss ratio was 70.8% and 64.4% in the first six months of 2011 and 2010, respectively, and 62.7% and 64.3% in the second quarter of 2011 and 2010, respectively. The 2011 catastrophe losses increased our reported gross loss ratios by 9.1 percentage points in the first six months and 2.3 percentage points in the second quarter of 2011, while the 2010 catastrophe losses increased our reported gross loss ratio by 2.5 percentage points in the first six months of 2010.

The tables below detail, by segment, our net loss and loss adjustment expense, the amount of loss development included in our net loss and loss adjustment expense, and our net loss ratios.

	Six months ended June		Three months ended June	
	30,		30,	
	2011	2010	2011	2010
U.S. Property & Casualty	\$ 92,428	\$ 102,801	\$ 44,944	\$ 50,989

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

Professional Liability	138,015	132,942	71,752	65,342
Accident & Health	291,605	273,569	146,747	135,349
U.S. Surety & Credit	29,687	27,861	14,648	15,487
International	130,393	84,374	56,221	28,769
Exited Lines	(260)	3,960	(30)	3,050
Net loss and loss adjustment expense	\$ 681,868	\$ 625,507	\$ 334,282	\$ 298,986

27

Table of Contents

	Six months ended June		Three months ended June	
	2011	30, 2010	2011	30, 2010
Adverse (favorable) loss development:				
U.S. Property & Casualty	\$ 2,550	\$ 5,324	\$ 1,014	\$ 389
Professional Liability	16,984	2,224	10,757	612
Accident & Health	2,310	2,456	1,140	(268)
U.S. Surety & Credit	19	(4,199)	78	273
International	664	(6,691)	371	(6,591)
Exited Lines	(261)	3,052	(109)	2,741
Total adverse (favorable) loss development	22,266	2,166	13,251	(2,844)
Catastrophe losses	61,720	20,588	17,348	
All other net loss and loss adjustment expense	597,882	602,753	303,683	301,830
Net loss and loss adjustment expense	\$ 681,868	\$ 625,507	\$ 334,282	\$ 298,986
U.S. Property & Casualty	58.1%	59.2%	56.9%	60.2%
Professional Liability	67.9	60.9	70.1	60.5
Accident & Health	72.8	73.1	72.6	72.1
U.S. Surety & Credit	29.3	28.3	29.3	29.9
International	77.5	56.3	62.0	39.0
Consolidated net loss ratio	66.0%	61.6%	63.8%	59.0%
Consolidated accident year net loss ratio	63.9%	61.2%	61.2%	59.2%

Loss development represents an increase or decrease in estimates of ultimate losses related to prior accident years. Deficiencies and redundancies in ultimate loss estimates occur as we review our loss exposure with our actuaries, increasing or reducing estimates of our ultimate losses as a result of such reviews and as losses are finally settled or claims exposures change. See the Segment Operations section below for further discussion of the changes in our net loss and loss adjustment expense and net loss ratios within each segment. Our current accident year net loss ratio was higher in 2011, primarily due to the higher amount of catastrophe losses.

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

	Six months ended June 30,		Three months ended June	
	2011	2010	2011	2010
Net reserves for loss and loss adjustment expense payable at beginning of period	\$ 2,537,772	\$ 2,555,840	\$ 2,611,096	\$ 2,555,670
Net reserve additions from acquired businesses	645	8,110		
Foreign currency adjustment	27,986	(47,786)	5,770	(20,673)
Net loss and loss adjustment expense	681,868	625,507	334,282	298,986
	(635,326)	(573,354)	(338,203)	(265,666)

Net loss and loss adjustment expense
payments

**Net reserves for loss and loss adjustment
expense**

payable at end of period	\$ 2,612,945	\$ 2,568,317	\$ 2,612,945	\$ 2,568,317
---------------------------------	--------------	--------------	--------------	--------------

Net paid loss ratio	61.5%	56.4%	64.5%	52.5%
----------------------------	-------	-------	-------	-------

The net paid loss ratio was higher in 2011 primarily due to higher claims payments for our directors and officers (D&O) and property treaty product lines, including \$5.0 million related to the 2011 catastrophic events. These increases in our year-to-date and second quarter 2011 net paid loss ratios were partially offset by lower claims payments for our medical stop-loss, aviation and U.S. credit product lines. In addition, in 2011 we commuted certain loss reserves included in our Exited Lines for \$33.6 million. These commutations increased our net paid loss ratios by 3.2 percentage points and 6.4 percentage points for the first six months and second

Table of Contents

quarter of 2011, respectively. The amount of claims paid fluctuates period to period due to our mix of business and the timing of claims settlement and catastrophic events.

Policy Acquisition Costs

Our policy acquisition cost percentage was 16.3% and 15.9% in the first six months of 2011 and 2010, respectively, and 16.1% in both the second quarter of 2011 and 2010. In 2011, the \$11.6 million reduction of net earned premium due to reinstatement premium increased our year-to-date policy acquisition cost percentage by 0.2 percentage points. The remaining increase in our policy acquisition cost percentage year-over-year primarily related to higher average commission and premium tax expense in 2011 due to changes in the mix of business.

Other Operating Expense

Other operating expense was flat year-over-year and increased 2.0% quarter-over-quarter in 2011, primarily due to the combined effect of higher employee benefits expense in 2011, fluctuations in foreign currency rates period-over-period, and certain non-recurring costs in 2010. We recognized currency conversion benefit (expense) of \$2.0 million in the first six months and \$0.8 million in the second quarter of 2011, compared to \$(2.7) million in the first six months and \$(1.2) million in the second quarter of 2010. The first six months of 2010 included \$3.0 million of direct costs incurred in the first quarter to terminate a derivative contract.

For the first six months of 2011, 66% of our other operating expense related to compensation and benefits of our employees. We had 1,876 employees at June 30, 2011 compared to 1,893 a year earlier. Other operating expense included year-to-date stock-based compensation expense of \$7.8 million in 2011 and \$7.3 million in 2010. At June 30, 2011, there was approximately \$29.8 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 3.7 years.

Interest Expense

Interest expense on debt and short-term borrowings was \$11.0 million and \$10.6 million in the first six months of 2011 and 2010, respectively, and \$5.4 million and \$5.2 million in the second quarter of 2011 and 2010, respectively, primarily related to our fixed rate Senior Notes.

Income Tax Expense

Our effective income tax rate was 27.1% for the first six months of 2011, compared to 30.5% for the first six months of 2010. The lower effective rate in 2011 related to the increased benefit from tax-exempt investment income relative to a lower pretax income base.

Table of Contents**Segment Operations**

Each of our insurance segments bears risk for insurance coverage written within its portfolio of insurance products. Each segment generates income from premium written by our underwriting agencies, through third party agents and brokers, or on a direct basis. The insurance segments also write facultative or individual account reinsurance, as well as treaty reinsurance business. In some cases, we purchase reinsurance to limit the segments' net losses from both individual policy losses and multiple policy losses from catastrophic events. Our segments maintain disciplined expense management and a streamlined management structure, which results in favorable expense ratios. The following provides operational information about our five underwriting segments and our Investing segment.

U.S. Property & Casualty Segment

The following tables summarize the operations of the U.S. Property & Casualty segment.

	Six months ended June		Three months ended June	
	30,	30,	30,	30,
	2011	2010	2011	2010
Net earned premium	\$ 159,175	\$ 173,625	\$ 78,921	\$ 84,695
Other revenue	9,666	19,095	4,787	6,204
Segment revenue	168,841	192,720	83,708	90,899
Loss and loss adjustment expense, net	92,428	102,801	44,944	50,989
Other expense	55,575	54,601	27,169	23,734
Segment expense	148,003	157,402	72,113	74,723
Segment pretax earnings	\$ 20,838	\$ 35,318	\$ 11,595	\$ 16,176
Net loss ratio	58.1%	59.2%	56.9%	60.2%
Expense ratio	32.9	28.3	32.5	26.1
Combined ratio	91.0%	87.5%	89.4%	86.3%
Aviation	\$ 54,600	\$ 58,298	\$ 27,318	\$ 29,355
E&O	38,357	51,066	18,800	24,834
Public Risk	23,179	22,926	11,927	11,436
Other	43,039	41,335	20,876	19,070
Total net earned premium	\$ 159,175	\$ 173,625	\$ 78,921	\$ 84,695
Aviation	63.7%	59.3%	68.9%	61.9%
E&O	57.3	62.8	55.0	62.7
Public Risk	66.9	69.6	60.5	69.2
Other	46.8	48.9	41.0	49.0
Total net loss ratio	58.1%	59.2%	56.9%	60.2%

Table of Contents

	Six months ended June		Three months ended June	
	30,	2010	30,	2010
	2011	2010	2011	2010
Aviation	\$ 79,056	\$ 76,908	\$ 37,608	\$ 39,387
E&O	36,998	44,298	17,305	20,707
Public Risk	34,298	34,691	16,845	17,979
Other	115,159	113,232	64,203	53,434
Total gross written premium	\$ 265,511	\$ 269,129	\$ 135,961	\$ 131,507
Aviation	\$ 59,085	\$ 53,750	\$ 31,691	\$ 27,729
E&O	36,586	44,237	17,020	20,707
Public Risk	26,396	23,650	13,144	14,445
Other	58,369	41,830	31,859	20,340
Total net written premium	\$ 180,436	\$ 163,467	\$ 93,714	\$ 83,221

Our U.S. Property & Casualty segment pretax earnings declined in 2011, primarily due to lower net earned premium and the effect of a \$5.0 million gain in 2010 related to termination of a derivative contract. The impact of these items was partially offset by \$2.8 million more adverse development in 2010 than in 2011.

Gross written premium was lower in 2011 due to competition and other business factors that particularly affected the E&O product line. E&O premium was also impacted by our more restrictive underwriting of this product line starting in 2009. Total net written premium increased in certain other product lines, as changes in the timing and amount of our reinsurance program costs offset the decrease in E&O premium. Net earned premium was lower in 2011 mainly due to reduced E&O premium.

The segment's lower net loss ratios in 2011, compared to 2010, primarily reflect the change in loss development year-over-year. The segment had adverse development of \$2.5 million in the first six months of 2011, compared to \$5.3 million in the same period of 2010. The 2011 development primarily related to our employment practices liability product (included in Other), while the 2010 development primarily related to our E&O and employment practices liability product lines.

The segment's higher 2011 expense ratios primarily related to higher compensation costs and lower segment revenue in 2011 compared to 2010. During 2010, we terminated our interest in a derivative contract, which generated \$5.0 million of pretax earnings. We recognized a gain of \$8.0 million, which was included in other revenue, and incurred reinsurance and other direct costs of \$3.0 million, which were included in other expense.

Table of Contents**Professional Liability Segment**

The following tables summarize the operations of the Professional Liability segment. In the second quarter of 2011, we combined the presentation of our U.S. D&O and Other products as they are now under common management.

	Six months ended June		Three months ended June	
	30, 2011	2010	30, 2011	2010
Net earned premium	\$ 203,174	\$ 218,153	\$ 102,424	\$ 108,001
Other revenue	249	438	48	107
Segment revenue	203,423	218,591	102,472	108,108
Loss and loss adjustment expense, net	138,015	132,942	71,752	65,342
Other expense	34,032	38,305	16,928	18,767
Segment expense	172,047	171,247	88,680	84,109
Segment pretax earnings	\$ 31,376	\$ 47,344	\$ 13,792	\$ 23,999
Net loss ratio	67.9%	60.9%	70.1%	60.5%
Expense ratio	16.7	17.5	16.5	17.4
Combined ratio	84.6%	78.4%	86.6%	77.9%
U.S. D&O	\$ 180,254	\$ 192,379	\$ 90,279	\$ 95,667
International D&O	22,920	25,774	12,145	12,334
Total net earned premium	\$ 203,174	\$ 218,153	\$ 102,424	\$ 108,001
U.S. D&O	69.3%	61.0%	72.2%	60.2%
International D&O	57.2	60.5	54.3	62.6
Total net loss ratio	67.9%	60.9%	70.1%	60.5%
U.S. D&O	\$ 200,661	\$ 220,144	\$ 123,470	\$ 133,272
International D&O	61,611	49,372	37,682	28,519
Total gross written premium	\$ 262,272	\$ 269,516	\$ 161,152	\$ 161,791
U.S. D&O	\$ 153,692	\$ 159,011	\$ 94,081	\$ 96,630
International D&O	36,956	19,814	22,776	11,321
Total net written premium	\$ 190,648	\$ 178,825	\$ 116,857	\$ 107,951

Our Professional Liability segment earnings declined in 2011 due to lower net earned premium and more adverse loss development compared to 2010. Gross written premium decreased in 2011 because we wrote less D&O business in the United States due to competition. Net written premium as a percentage of gross written premium was higher in 2011 due to a change in our reinsurance programs. We are now purchasing less reinsurance on both our U.S. D&O and International D&O products.

The segment had adverse loss development of \$17.0 million and \$2.2 million in the first six months of 2011 and 2010, respectively, and \$10.8 million and \$0.6 million in the second quarter of 2011 and 2010, respectively. The 2011 development primarily related to

Table of Contents

the Club Deal claims discussed in the Results of Operations section above. In the second quarter of 2011, our estimate of net losses for these claims, which primarily related to the 2006 underwriting year for our diversified financial products line of business, increased by \$10.8 million. These losses increased the U.S. D&O net loss ratio by 6.0 percentage points and 11.9 percentage points in the first six months and second quarter of 2011, respectively.

Accident & Health Segment

The following tables summarize the operations of the Accident & Health segment.

	Six months ended June		Three months ended June	
	2011	2010	2011	2010
Net earned premium	\$ 400,657	\$ 374,487	\$ 202,117	\$ 187,703
Other revenue	2,194	1,717	1,178	867
Segment revenue	402,851	376,204	203,295	188,570
Loss and loss adjustment expense, net	291,605	273,569	146,747	135,349
Other expense	61,995	59,059	31,577	30,323
Segment expense	353,600	332,628	178,324	165,672
Segment pretax earnings	\$ 49,251	\$ 43,576	\$ 24,971	\$ 22,898
Net loss ratio	72.8%	73.1%	72.6%	72.1%
Expense ratio	15.4	15.7	15.5	16.1
Combined ratio	88.2%	88.8%	88.1%	88.2%
Medical Stop-loss	\$ 351,056	\$ 323,558	\$ 176,147	\$ 161,792
Other	49,601	50,929	25,970	25,911
Total net earned premium	\$ 400,657	\$ 374,487	\$ 202,117	\$ 187,703
Medical Stop-loss	74.0%	73.9%	74.1%	74.0%
Other	64.2	67.4	62.2	60.2
Total net loss ratio	72.8%	73.1%	72.6%	72.1%
Medical Stop-loss	\$ 351,154	\$ 323,558	\$ 176,197	\$ 161,792
Other	46,669	49,850	25,326	27,438
Total gross written premium	\$ 397,823	\$ 373,408	\$ 201,523	\$ 189,230
Medical Stop-loss	\$ 351,056	\$ 323,558	\$ 176,147	\$ 161,792

Other	46,444	49,661	25,248	27,344
Total net written premium	\$ 397,500	\$ 373,219	\$ 201,395	\$ 189,136

Our Accident & Health segment pretax earnings increased 13% in 2011, primarily due to higher medical stop-loss premium from rate increases and writing new business. The segment had adverse loss development of \$2.3 million in the first six months of 2011 and \$2.5 million in the same period of 2010. The adverse development primarily related to our short-term medical insurance and HMO reinsurance products (both included in Other).

Table of Contents**U.S. Surety & Credit Segment**

The following tables summarize the operations of the U.S. Surety & Credit segment.

	Six months ended June		Three months ended June	
	30,		30,	
	2011	2010	2011	2010
Net earned premium	\$ 101,403	\$ 98,620	\$ 50,039	\$ 51,871
Other revenue	701	328	455	205
Segment revenue	102,104	98,948	50,494	52,076
Loss and loss adjustment expense, net	29,687	27,861	14,648	15,487
Other expense	55,252	53,692	26,997	26,836
Segment expense	84,939	81,553	41,645	42,323
Segment pretax earnings	\$ 17,165	\$ 17,395	\$ 8,849	\$ 9,753
Net loss ratio	29.3%	28.3%	29.3%	29.9%
Expense ratio	54.1	54.3	53.5	51.5
Combined ratio	83.4%	82.6%	82.8%	81.4%
Surety	\$ 80,809	\$ 79,548	\$ 40,148	\$ 39,531
Credit	20,594	19,072	9,891	12,340
Total net earned premium	\$ 101,403	\$ 98,620	\$ 50,039	\$ 51,871
Surety	25.3%	25.3%	25.2%	25.5%
Credit	44.9	40.7	45.8	43.9
Total net loss ratio	29.3%	28.3%	29.3%	29.9%
Surety	\$ 86,962	\$ 88,700	\$ 45,257	\$ 47,754
Credit	26,991	28,470	14,925	15,395
Total gross written premium	\$ 113,953	\$ 117,170	\$ 60,182	\$ 63,149
Surety	\$ 82,743	\$ 85,310	\$ 42,985	\$ 45,925
Credit	22,358	22,249	12,409	14,215
Total net written premium	\$ 105,101	\$ 107,559	\$ 55,394	\$ 60,140

Our U.S. Surety & Credit segment pretax earnings were flat year-over-year. The segment had minimal loss development in the first six months of 2011, compared to favorable development of \$4.2 million in the same period of 2010. The favorable development related to revised loss estimates for large losses in our credit product line in 2009 and 2008, stemming from weak economic conditions in the world credit markets.

Table of Contents**International Segment**

The following tables summarize the operations of the International segment.

	Six months ended June		Three months ended June	
	30,	30,	30,	30,
	2011	2010	2011	2010
Net earned premium	\$ 168,164	\$ 149,932	\$ 90,717	\$ 73,765
Other revenue	1,902	4,711	894	1,666
Segment revenue	170,066	154,643	91,611	75,431
Loss and loss adjustment expense, net	130,393	84,374	56,221	28,769
Other expense	64,020	59,905	32,355	30,745
Segment expense	194,413	144,279	88,576	59,514
Segment pretax income (loss)	\$ (24,347)	\$ 10,364	\$ 3,035	\$ 15,917
Net loss ratio	77.5%	56.3%	62.0%	39.0%
Expense ratio	37.6	38.7	35.3	40.8
Combined ratio	115.1%	95.0%	97.3%	79.8%
Energy	\$ 28,683	\$ 26,789	\$ 16,634	\$ 10,602
Property Treaty	37,965	15,609	21,961	8,855
Liability	39,898	40,549	19,966	19,777
Surety & Credit	36,057	35,884	18,683	17,695
Other	25,561	31,101	13,473	16,836
Total net earned premium	\$ 168,164	\$ 149,932	\$ 90,717	\$ 73,765
Energy	59.8%	35.9%	44.5%	(27.0)%
Property Treaty	103.4	103.5	86.5	47.5
Liability	51.2	55.1	50.6	54.4
Surety & Credit	41.2	38.4	42.0	32.7
Other	151.3	72.2	88.2	64.7
Total net loss ratio	77.5%	56.3%	62.0%	39.0%
Energy	\$ 96,381	\$ 80,322	\$ 80,078	\$ 63,740
Property Treaty	104,115	55,095	32,296	17,465
Liability	48,071	49,037	23,953	21,090
Surety & Credit	47,189	40,245	20,516	18,940
Other	55,825	58,079	26,390	24,201

Total gross written premium	\$ 351,581	\$ 282,778	\$ 183,233	\$ 145,436
------------------------------------	------------	------------	------------	------------

35

Table of Contents

	Six months ended June		Three months ended June	
	30,	30,	30,	30,
	2011	2010	2011	2010
Energy	\$ 62,897	\$ 47,465	\$ 57,845	\$ 37,623
Property Treaty	86,126	49,046	24,966	13,789
Liability	44,433	45,747	22,073	19,570
Surety & Credit	43,466	36,673	18,708	17,037
Other	38,000	42,188	18,890	18,072
Total net written premium	\$ 274,922	\$ 221,119	\$ 142,482	\$ 106,091

Our International segment's pretax earnings were impacted by losses from world-wide catastrophic events in 2011 and 2010. We experienced catastrophe losses primarily from the Japan earthquake and tsunami, the New Zealand earthquakes and the United States tornados in the first and second quarters of 2011, and from the Chile earthquake in the first quarter of 2010. The catastrophic events impacted our energy and property treaty product lines, as well as our property (direct and facultative) and accident and health product lines (both included in Other). We reinsured a portion of our exposure to these catastrophic events and incurred net reinstatement premium for continued reinsurance coverage, which reduced the segment's 2011 net written and net earned premium. The following table summarizes the segment's catastrophe losses, as well as the impact on key metrics in 2011 and 2010:

	Six months ended June		Three months ended June	
	30,	30,	30,	30,
	2011	2010	2011	2010
Loss and loss adjustment expense, after reinsurance	\$ 60,672	\$ 20,588	\$ 18,300	\$
Reinstatement premium, net	11,608		4,515	
Total net catastrophe losses	\$ 72,280	\$ 20,588	\$ 22,815	\$
Impact of net catastrophe losses:				
Net loss ratio (in percentage points)	38.7%	13.8%	22.2%	%
Expense ratio (in percentage points)	2.4		1.6	
Combined ratio	41.1%	13.8%	23.8%	%

The increase in gross written, net written and net earned premium principally related to our new property treaty business, which we began to write in late 2009. In the second quarter of 2011, we wrote more energy business due to industry rate increases and expansion of our wind storm aggregates. Other revenue in 2010 included third party revenue earned by our reinsurance broker, which we sold in late 2009.

The energy, property treaty and Other net loss ratios reflect the catastrophe losses in the first six months of 2011 and 2010. The segment had \$0.7 million of adverse loss development in the first six months of 2011, compared to \$6.7 million of favorable development in the same period of 2010. The 2011 development included \$4.4 million of adverse development primarily related to the 2010 catastrophic events, offset by \$4.0 million of favorable development related to the 2008 hurricanes. The 2010 development primarily related to the 2008 hurricanes and generated a (27.0)% net loss ratio for our energy product in the second quarter of 2010.

The segment's lower 2011 expense ratios primarily related to higher segment revenue in 2011 compared to 2010, as well as currency conversion expense in 2010.

Table of Contents**Investing Segment**

We invest substantially all of our funds in highly-rated fixed income securities, the majority of which are designated as available for sale securities. We held \$5.6 billion of fixed income securities at June 30, 2011, compared to \$5.2 billion at December 31, 2010. At June 30, 2011, 99% of our fixed income securities were investment grade, of which 82% were rated AAA or AA. The average long-term tax equivalent yield of our fixed income securities portfolio was 4.8% on June 30, 2011. The portfolio has a weighted-average life of 7.2 years and a weighted-average duration of 5.3 years.

The following tables summarize the investment results and key metrics related to our Investing segment.

	Six months ended June 30,		Three months ended June 30,	
	2011	2010	2011	2010
Fixed income securities	\$ 104,045	\$ 99,080	\$ 52,039	\$ 50,481
Short-term investments	321	360	165	170
Other investments	2,030	2,042	1,388	534
Net realized investment gain	495	6,840	1,054	2,315
Other-than-temporary impairment credit losses	(3,479)		(350)	
Investment expenses	(2,379)	(2,016)	(1,170)	(968)
Segment pretax earnings	\$ 101,033	\$ 106,306	\$ 53,126	\$ 52,532
Average investments, at cost	\$ 5,608,268	\$ 5,324,304	\$ 5,636,180	\$ 5,338,843
Average long-term yield *	3.9%	4.1%	3.9%	4.1%
Average long-term tax equivalent yield *	4.8%	5.0%	4.7%	5.0%
Average combined tax equivalent yield *	4.5%	4.5%	4.5%	4.5%
Weighted-average life of fixed income securities	7.2 years	6.5 years		
Weighted-average duration of fixed income securities	5.3 years	4.8 years		
Weighted-average combined duration	5.1 years	4.4 years		
Average rating of fixed income securities	AA+	AA+		

* Excluding realized and unrealized gains and losses.

The ratings of our fixed income securities at June 30, 2011 were as follows:

	Available for sale at fair value		Held to maturity at amortized cost	
	Amount	%	Amount	%
AAA	\$ 2,544,250	47%	\$ 61,787	35%
AA	1,959,246	36	29,284	17
A	784,080	14	81,639	47
BBB	116,436	2	1,283	1
BB and below	30,749	1		
Total fixed income securities	\$ 5,434,761	100%	\$ 173,993	100%

Table of Contents

This table summarizes our investments by type, substantially all of which were reported at fair value, at June 30, 2011 and December 31, 2010.

	June 30, 2011		December 31, 2010	
	Amount	%	Amount	%
U.S. government and government agency securities	\$ 370,352	6%	\$ 337,260	6%
Fixed income securities of states, municipalities and political subdivisions	1,047,341	18	1,082,057	19
Special purpose revenue bonds of states, municipalities and political subdivisions	1,630,380	28	1,628,059	29
Corporate fixed income securities	823,130	14	683,690	12
Residential mortgage-backed securities	1,149,598	20	995,108	17
Commercial mortgage-backed securities	235,732	4	145,228	3
Asset-backed securities	40,738	1	12,566	
Foreign government securities	311,483	5	309,140	5
Short-term investments	194,507	3	488,002	9
Other investments	31,942	1	5,985	
Total investments	\$ 5,835,203	100%	\$ 5,687,095	100%

Our total investments increased \$148.1 million in 2011, principally from operating cash flow. In the past twelve months, we substantially reduced our short-term investments, and re-invested the funds in long-term fixed income securities, in order to maximize our investment return.

The methodologies used to determine the fair value of our investments are described in Note 2, Fair Value Measurements, to the Consolidated Financial Statements. At June 30, 2011, the net unrealized gain on our available for sale fixed income securities portfolio was \$194.0 million, compared to \$116.4 million at March 31, 2011 and \$134.6 million at December 31, 2010. The change in the net unrealized gain or loss, net of the related income tax effect, is recorded in other comprehensive income. Our general policy has been to hold our available for sale fixed income securities through periods of fluctuating interest rates.

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 individual securities within our available for sale fixed income securities was \$16.4 million at June 30, 2011 and \$35.6 million at December 31, 2010. We evaluate the securities in our fixed income securities portfolio for possible other-than-temporary impairment losses at each quarter end. We recognized \$3.5 million and \$0.4 million of other-than-temporary impairment credit losses in the first six months and second quarter of 2011, and none in the same periods of 2010. For additional disclosures about these credit losses and a description of the accounting policies and procedures that we use to determine our other-than-temporary impairment losses, see Note 3, Investments to the 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, 2010.

At June 30, 2011, we held \$1.6 billion of special purpose revenue bonds, as well as \$1.0 billion of general obligation bonds, which are issued by states, municipalities and political subdivisions and collectively referred to, in the investment market, as municipal bonds. The overall rating of our municipal bonds was AA+ at June 30, 2011. Within our municipal bond portfolio, we held \$232.7 million of pre-refunded bonds, which are supported by U.S. government debt obligations. Our special purpose revenue bonds are secured by revenue sources specific to each security. At June 30, 2011, the percentages of our special purpose revenue bond portfolio supported by these major revenue sources were as follows: 1) water and sewer 25%, 2) education 18%, 3) transportation 16%, 4) special tax 9% and 5) pre-refunded bonds 7%.

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, 2011. Although recent

Table of Contents

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, as indicated above, which we believe generate a stable source of revenue.

At June 30, 2011, we held a commercial MBS securities portfolio with a fair value of \$235.7 million, an average rating of AA+ and an average loan-to-value ratio of 69%. We owned no collateralized debt obligations (CDOs) or collateralized loan obligations (CLOs), and we are not counterparty to any credit default swap transactions.

At June 30, 2011, we held \$174.0 million of fixed income securities that we designated as held to maturity. We maintain these securities, which are denominated in currencies other than the functional currency of the investing subsidiary, to hedge the currency conversion risk associated with insurance claims that we will pay in these securities. Effective in the first quarter of 2011, we discontinued designating new investment purchases as held to maturity securities and plan to designate future investment purchases as available for sale securities. Any unrealized currency conversion gains and losses on available for sale securities must be recorded in other comprehensive income within shareholders' equity, rather than in net earnings. The pretax income statement impact related to this change in our investment management philosophy approximated \$0.4 million in the first six months of 2011. This change will create greater volatility in our currency conversion benefit or expense in future periods. All currency conversion benefit or expense, except for the conversion gains and losses on available for sale securities, is recorded in Corporate & Other beginning in 2011.

Realized gains and losses from sales of securities are usually minimal, unless we sell securities for investee credit-related reasons, or because we can reinvest the proceeds at a higher effective yield. We recognized \$0.5 million of net realized investment gain in the first six months of 2011, compared to \$6.8 million gain in the same period of 2010.

Corporate & Other

The following table summarizes Corporate & Other activity.

	Six months ended June		Three months ended June	
	30,	30,	30,	30,
	2011	2010	2011	2010
Net earned premium	\$ 158	\$ 1,155	\$ 33	\$ 350
Other revenue	84	858	113	157
Total revenue	242	2,013	146	507
Loss and loss adjustment expense	(260)	3,960	(30)	3,050
Other expense Exited Lines	2,102	2,075	1,034	919
Other expense Corporate	23,198	23,243	12,300	12,930
Interest expense	10,734	10,260	5,305	5,130
Total expense	35,774	39,538	18,609	22,029
Pretax loss	\$ (35,532)	\$ (37,525)	\$ (18,463)	\$ (21,522)

Our Corporate expenses not allocable to the segments were flat year-over-year, primarily due to a \$2.0 million currency conversion benefit in the first six months of 2011, offset by higher information technology costs related to implementation of a new company-wide financial reporting system. Interest expense increased due to accelerated recognition of capitalized debt issuance costs in the first quarter of 2011 related to our previous Revolving Loan Facility, which we replaced in March 2011 (see further discussion below).

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 \$281.7 million of unrestricted cash and liquid short-term investments at June 30, 2011.

Table of Contents

Our available for sale bond portfolio, of which \$128.2 million was held directly by the parent company, had a fair value of \$5.4 billion at June 30, 2011, compared to \$5.0 billion at December 31, 2010, 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.

In March 2011, we replaced our \$575.0 million Revolving Loan Facility with a four-year \$600.0 million Revolving Loan Facility that matures on March 8, 2015, of which \$492.1 million of borrowing capacity remained at June 30, 2011.

Our long-term 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 10.7% at June 30, 2011 and 8.3% December 31, 2010, with the increase related to our borrowings under the Revolving Loan Facility.

We have a \$90.0 million Standby Letter of Credit Facility, which is used to guarantee our performance in two Lloyd's of London syndicates, that expires on December 31, 2014.

Our domestic insurance subsidiaries have the ability to pay \$183.6 million in dividends to the parent company in 2011 without obtaining special permission from state regulatory authorities. Our underwriting agencies have no restrictions on the amount of dividends that can be paid. HCC can utilize these dividends for any purpose, including to pay down debt, pay dividends to shareholders, fund acquisitions, purchase our common stock and pay operating expenses.

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.

Capital Management

Revolving Loan Facility

On March 8, 2011, we entered into a new agreement for a four-year \$600.0 million Revolving Loan Facility (Facility). The Facility replaced our \$575.0 million Revolving Loan Facility, which was due to expire on December 19, 2011. The Facility allows us to borrow up to the maximum allowed on a revolving basis until the Facility expires on March 8, 2015. As of June 30, 2011, we had borrowed \$95.0 million under the Facility to fund repurchases of our common stock. The borrowing rate is LIBOR plus 137.5 basis points, subject to increase or decrease based on changes in our debt rating. The contractual interest rate on borrowings under the Facility at June 30, 2011 was 1.61%. In addition, we pay a commitment fee of 20 basis points. Letters of credit issued under the Facility further reduced our available borrowing capacity on the remaining Facility to \$492.1 million at June 30, 2011. The Facility contains restrictive financial covenants that require HCC to maintain a minimum consolidated net worth (excluding accumulated other comprehensive income) and a leverage ratio of less than or equal to 35%. We were in compliance with these covenants at June 30, 2011.

Senior Notes

In 2009, we issued \$300.0 million of 6.30% Senior Notes due 2019. The Senior Notes were priced at a discount of \$1.5 million, for an effective interest rate of 6.37%. We pay interest semi-annually in arrears on May 15 and November 15 of each year. The Senior Notes may be redeemed in whole at any time or in part from time to time, at our option, at the redemption price determined in the manner described in the indenture governing the Senior Notes. The indenture contains restrictive covenants that impose conditions on our ability to create liens on any capital stock of our restricted subsidiaries (as defined in the indenture) or to engage in sales of the capital stock of our restricted subsidiaries. We were in compliance with the requirements of these covenants at June 30, 2011.

Standby Letter of Credit Facility

In 2010, we entered into a \$90.0 million Standby Letter of Credit Facility (Standby Facility) that is used to guarantee our performance in two Lloyds of London syndicates. The Standby Facility expires on December 31, 2014. We pay an annual fee of 90 basis points. The Standby Facility contains restrictive financial covenants that require HCC to maintain a minimum consolidated net worth (excluding accumulated other comprehensive income) and a leverage ratio of less than or equal to 35%. We were in compliance with these covenants at June 30, 2011.

Table of Contents**Share Repurchases**

On March 10, 2011, the Board approved the purchase of up to \$300.0 million of our common stock (the Plan). Purchases may be made in the open market or in privately negotiated transactions from time-to-time in compliance with applicable laws, rules and regulations, including Rule 10b-18 under the Securities Exchange Act of 1934, as amended. Purchases under the Plan will be made opportunistically from time to time at prices approved by the Board of Directors, subject to market and business conditions, the level of cash generated from our operations, cash required for acquisitions, our debt covenant compliance, and other relevant factors. The Plan does not obligate us to purchase any particular number of shares, has no expiration date, and may be suspended or discontinued at any time at the Board's discretion. In the second quarter of 2011, we purchased \$161.4 million, or 5.0 million shares, at an average cost of \$32.06 per share. We purchased \$201.7 million, or 6.3 million shares, at an average cost of \$31.78 in the first six months of 2011.

Earnouts

We acquired HCC Global Financial Products (HCC Global), which underwrites our U.S. and International directors and officers' liability business, in 2002. The purchase agreement, as amended, includes a contingency for future earnout payments. The earnout is based on HCC Global's pretax earnings from the acquisition date through September 30, 2007, with no maximum amount due to the former owners. When conditions specified under the purchase agreement are met, we record a net amount owed to or due from the former owners based on our estimate, at that point in time, of how claims will ultimately be settled. This net amount will fluctuate in the future, and the ultimate total net earnout payments cannot be finally determined until all claims are settled or paid. In March 2011, certain amendments were made to the purchase agreement, which resulted in an adjustment to our estimate of the ultimate amounts to be settled under the agreement. As a result, we increased goodwill by \$20.0 million as of March 31, 2011.

Cash Flow

We receive substantial cash from premiums, reinsurance recoverables, surety collateral, outward commutations, proceeds 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, return of surety collateral, 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 premium receivables, reinsurance recoverables and surety collateral; the payment of losses, premium payables and return of surety collateral; and the completion of commutations.

We generated cash from operations of \$121.8 million and \$139.3 million in the first six months of 2011 and 2010, respectively. The components of our net operating cash flows are summarized in the following table.

	Six months ended June 30,	
	2011	2010
Net earnings	\$ 116,468	\$ 154,734
Change in premium, claims and other receivables, net of reinsurance, premium and claims payables and excluding restricted cash	(133,658)	(67,355)
Change in unearned premium, net	99,885	27,911
Change in loss and loss adjustment expense payable, net of reinsurance recoverables	63,142	39,357
(Gain) loss on investments	2,984	(7,329)
Other, net	(27,037)	(7,992)
Cash provided by operating activities	\$ 121,784	\$ 139,326

Cash provided by operating activities was lower in 2011 than in 2010 primarily due to higher claims payments, activity related to surety collateral funds, and inward commutations completed in 2011. We paid \$28.3 million more claims in 2011 compared to 2010, of which \$5.0 million related to the 2011 catastrophic events, and had an

\$18.4 million net outflow of surety collateral funds. In 2011, we also paid \$33.6 million to commute certain loss reserves in our Exited lines, which reduced our 2011 operating cash flow.

Table of Contents

Recent Accounting Guidance

See Note 1, General Information to the Consolidated Financial Statements for a description of recently issued accounting guidance that will impact our consolidated financial statements in future periods.

Critical Accounting Policies

We provided information about our critical accounting policies 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, 2010. We have made no changes in the identification or methods of application of these policies.

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, 2010.

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, 2011. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of June 30, 2011.

(b) Changes in Internal Control over Financial Reporting

During the second quarter of 2011, we identified no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2011 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, 2010.

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

On March 10, 2011, the Board approved the purchase of up to \$300.0 million of our common stock (the Plan). Purchases may be made in the open market or in privately negotiated transactions from time-to-time in compliance with applicable laws, rules and regulations, including Rule 10b-18 under the Securities Exchange Act of 1934, as amended. Purchases under the Plan will be made opportunistically from time to time at prices approved by the Board of Directors, subject to market and business conditions, the level of cash generated from our operations, cash required for acquisitions, our debt covenant compliance, and other relevant factors. The Plan does not obligate us to purchase any particular number of shares, has no expiration date, and may be suspended or discontinued at any time at the Board's discretion.

During the second quarter of 2011, 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
April 1 - April 30, 2011	1,104,602	\$ 32.04	1,104,602	\$ 224,393,344
May 1 - May 31, 2011	1,715,142	\$ 32.41	1,715,142	\$ 168,810,882
June 1 - June 30, 2011	2,215,514	\$ 31.80	2,215,514	\$ 98,353,320

Item 3. Defaults Upon Senior Securities

None.

Item 4. [Removed and Reserved]**Item 5. Other Information**

None.

Table of Contents

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 Secretary of State of Delaware on July 23, 1996 and May 21, 1998, respectively (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8 (Registration No. 333-61687) filed on August 17, 1998).
- 3.2 Amended and Restated Bylaws of HCC Insurance Holdings, Inc. (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on April 3, 2008).
- 4.1 Indenture, dated August 23, 2001, between HCC Insurance Holdings, Inc. and First Union National Bank related to Debt Securities (incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed on August 24, 2001).
- 4.2 Form of Fourth Supplemental Indenture, dated November 16, 2009, between HCC Insurance Holdings, Inc. and U.S. Bank National Association related to the 6.30% Senior Notes due 2019 (incorporated by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed on November 13, 2009).
- 10.1 Employment Agreement, dated April 27, 2011, between HCC Insurance Holdings, Inc. and Christopher J.B. Williams (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 2, 2011).
- 10.2 HCC Insurance Holdings, Inc. Nonqualified Deferred Compensation Plan for Christopher J.B. Williams, effective May 1, 2011 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on May 2, 2011).
- 10.3 Relocation Policy and Reimbursement Agreement, dated April 27, 2011, between HCC Insurance Holdings, Inc. and Christopher J.B. Williams (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on May 2, 2011).
- 12 Statement of Ratios
- 31.1 Certification by Chief Executive Officer.
- 31.2 Certification by Chief Financial Officer.
- 32.1 Certification with Respect to Quarterly Report.
- 101 The following financial statements from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Earnings, (iii) Consolidated Statement of Changes in Shareholders' Equity, (iv) Consolidated Statements of Cash Flows and (v) Notes to Consolidated Financial Statements.*

- * 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 8, 2011
(Date)

/s/ John N. Molbeck, Jr.
John N. Molbeck, Jr.,
Chief Executive Officer

August 8, 2011
(Date)

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