

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

August 08, 2011

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**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
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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,

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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.

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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.

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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 30, | |
|---|---------------------------|-------------------|-----------------------------|------------------|
| | 2011 | 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.

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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.

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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.

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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:

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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.

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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 |

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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.

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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 |

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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 | | |
|---|------------------------------|-----------------------------|-----------------------------|-------------------|
| | | Gross unrealized gain | Gross unrealized loss | Fair value |
| <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) |

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

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| | 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

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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 |

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

| | Six months ended June 30, | | Three months ended June 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.

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(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 31, |
|---|-----------------|---------------------|
| | 2011 | 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 |
|---------------------------------------|--------------|--------------|

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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 |

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(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 |

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(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

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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 & Health | | | U.S. Surety & Credit International Investing | | | Corporate & Other Consolidated | |
|---------------------------------------|--|------------------|------------------|--|----------------------|-------------------|-----------------------------------|---------------------|
| Six months ended June 30, 2011 | Casualty | Liability | Health | & Credit | International | Investing | & Other | Consolidated |
| 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 |

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| 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 | \$ 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 | \$ 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.

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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 | | | |

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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.

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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.

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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.

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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 |

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| | | | | |
|---|-------------------|-------------------|-------------------|-------------------|
| 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 |

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| | 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

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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, | |
| | 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% |

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| | 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

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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 | |
|---------------------------------------|-----------------------|-------------------|-------------------------|-------------------|
| | 30, | 30, | 30, | 30, |
| | 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 | |
|---------------------------------------|-----------------------|-------------------|-------------------------|------------------|
| | 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 |
|------------------------------------|------------|------------|------------|------------|

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| | Six months ended June | | Three months ended June | |
|----------------------------------|------------------------------|-------------------|--------------------------------|-------------------|
| | 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, | |
| | 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% |

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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

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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.

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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.

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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.

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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.

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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