

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

November 07, 2011

**Table of Contents**

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

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the Quarterly Period Ended September 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 October 28, 2011, there were approximately 106.5 million shares of common stock outstanding.

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**HCC Insurance Holdings, Inc. and Subsidiaries  
Table of Contents**

	<b>Page</b>
<b><u>Part I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements</u></b>	
<u>Consolidated Balance Sheets – September 30, 2011 and December 31, 2010</u>	5
<u>Consolidated Statements of Earnings – Nine months and three months ended September 30, 2011 and 2010</u>	6
<u>Consolidated Statement of Changes in Shareholders' Equity – Nine months ended September 30, 2011</u>	7
<u>Consolidated Statements of Cash Flows – Nine months ended September 30, 2011 and 2010</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	24
<b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>	42
<b><u>Item 4. Controls and Procedures</u></b>	42
<b><u>Part II. OTHER INFORMATION</u></b>	
<b><u>Item 1. Legal Proceedings</u></b>	43
<b><u>Item 1A. Risk Factors</u></b>	43
<b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	43
<b><u>Item 3. Defaults Upon Senior Securities</u></b>	43
<b><u>Item 4. [Removed and Reserved]</u></b>	43
<b><u>Item 5. Other Information</u></b>	43
<b><u>Item 6. Exhibits</u></b>	44
<b><u>Signatures</u></b>	45
<u>EX-12</u>	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32</u>	
<u>EX-101 INSTANCE DOCUMENT</u>	
<u>EX-101 SCHEMA DOCUMENT</u>	
<u>EX-101 CALCULATION LINKBASE DOCUMENT</u>	

EX-101 LABELS LINKBASE DOCUMENT

EX-101 PRESENTATION LINKBASE DOCUMENT

EX-101 DEFINITION LINKBASE DOCUMENT

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

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

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

*the effects of catastrophe losses,*

*the cyclical nature of the insurance business,*

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

*the impact of past and future potential credit market downturns, including the potential future ratings downgrade and/or impairment or perceived impairment of debt securities of sovereign issuers, including the United States of America,*

*the effects of emerging claim and coverage issues,*

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

*potential credit risk with brokers,*

*the effects of industry consolidations,*

*our assessment of underwriting risk,*

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

*the adequacy of reinsurance protection,*

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

*the occurrence of terrorist activities,*

*our ability to maintain our competitive position,*

*changes in our assigned financial strength ratings,*

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

*attraction and retention of qualified employees,*

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

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

*impairment of goodwill,*

**Table of Contents**

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

*fluctuations in foreign exchange rates,*

*failures or constraints of our information technology systems,*

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

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

*change of control, and*

*difficulties with outsourcing relationships.*

*We describe these risks and uncertainties in greater detail in Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010.*

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

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



**Table of Contents**

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

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
<b>ASSETS</b>		
Investments		
Fixed income securities available for sale, at fair value (amortized cost: 2011 \$5,356,333; 2010 \$4,864,806)	\$ 5,651,189	\$ 4,999,440
Fixed income securities held to maturity, at amortized cost (fair value: 2011 \$170,556; 2010 \$195,811)	168,614	193,668
Short-term investments, at cost, which approximates fair value	197,986	488,002
Other investments	34,297	5,985
<b>Total investments</b>	<b>6,052,086</b>	<b>5,687,095</b>
Cash	93,137	97,857
Restricted cash	227,562	148,547
Premium, claims and other receivables	677,641	635,867
Reinsurance recoverables	1,071,266	1,006,855
Ceded unearned premium	231,537	278,663
Ceded life and annuity benefits	56,868	58,409
Deferred policy acquisition costs	225,190	212,786
Goodwill	873,375	821,648
Other assets	133,326	116,355
<b>Total assets</b>	<b>\$ 9,641,988</b>	<b>\$ 9,064,082</b>
<b>LIABILITIES</b>		
Loss and loss adjustment expense payable	\$ 3,686,570	\$ 3,471,858
Life and annuity policy benefits	56,868	58,409
Reinsurance, premium and claims payable	321,684	345,730
Unearned premium	1,071,340	1,045,877
Deferred ceding commissions	66,059	72,565
Notes payable	493,752	298,637
Accounts payable and accrued liabilities	678,576	474,574
<b>Total liabilities</b>	<b>6,374,849</b>	<b>5,767,650</b>
<b>SHAREHOLDERS EQUITY</b>		
Common stock, \$1.00 par value; 250,000 shares authorized (shares issued: 2011 122,661 and 2010 120,942; outstanding: 2011 106,511 and 2010	122,661	120,942

114,968)		
Additional paid-in capital	998,585	954,332
Retained earnings	2,385,638	2,257,895
Accumulated other comprehensive income	202,018	97,186
Treasury stock, at cost (shares: 2011 16,150 and 2010 5,974)	(441,763)	(133,923)
<b>Total shareholders equity</b>	<b>3,267,139</b>	<b>3,296,432</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 9,641,988</b>	<b>\$ 9,064,082</b>

See Notes to Consolidated Financial Statements.

5

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**Table of Contents**

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

	Nine months ended September 30,		Three months ended September 30,	
	2011	2010	2011	2010
<b>REVENUE</b>				
Net earned premium	\$ 1,576,987	\$ 1,532,138	\$ 544,256	\$ 516,166
Net investment income	158,782	150,603	54,765	51,137
Other operating income	23,625	35,035	8,829	7,888
Net realized investment gain	3,169	7,897	2,674	1,057
Other-than-temporary impairment credit losses	(3,479)	(300)		(300)
<b>Total revenue</b>	<b>1,759,084</b>	<b>1,725,373</b>	<b>610,524</b>	<b>575,948</b>
<b>EXPENSE</b>				
Loss and loss adjustment expense, net	1,062,240	922,645	380,372	297,138
Policy acquisition costs, net	239,160	242,078	71,299	80,748
Other operating expense	198,511	189,953	70,451	60,770
Interest expense	16,597	15,907	5,610	5,280
<b>Total expense</b>	<b>1,516,508</b>	<b>1,370,583</b>	<b>527,732</b>	<b>443,936</b>
Earnings before income tax expense	242,576	354,790	82,792	132,012
Income tax expense	65,671	106,993	22,355	38,949
<b>Net earnings</b>	<b>\$ 176,905</b>	<b>\$ 247,797</b>	<b>\$ 60,437</b>	<b>\$ 93,063</b>
<b>Earnings per common share</b>				
Basic	\$ 1.58	\$ 2.15	\$ 0.56	\$ 0.81
Diluted	\$ 1.57	\$ 2.15	\$ 0.56	\$ 0.81

See Notes to Consolidated Financial Statements.

Table of Contents

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

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Treasury stock	Total shareholders equity
<b>Balance at December 31, 2010</b>	\$ 120,942	\$ 954,332	\$ 2,257,895	\$ 97,186	\$ (133,923)	\$ 3,296,432
Comprehensive income						
Net earnings			176,905			176,905
Other comprehensive income						
Change in net unrealized gain on investments, net of tax				104,776		104,776
Other, net of tax				56		56
Total other comprehensive income						104,832
Comprehensive income						
						281,737
Issuance of 1,458 shares for exercise of options, including tax effect	1,458	34,787				36,245
Purchase of 10,176 common shares					(307,840)	(307,840)
Stock-based compensation	261	9,466				9,727
Cash dividends declared, \$0.445 per share			(49,162)			(49,162)
<b>Balance at September 30, 2011</b>	\$ 122,661	\$ 998,585	\$ 2,385,638	\$ 202,018	\$ (441,763)	\$ 3,267,139

See Notes to Consolidated Financial Statements.

**Table of Contents**

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

	<b>Nine months ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>Operating activities</b>		
Net earnings	\$ 176,905	\$ 247,797
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Change in premium, claims and other receivables	(76,927)	(36,040)
Change in reinsurance recoverables	(56,510)	(32,474)
Change in ceded unearned premium	47,477	(15,368)
Change in loss and loss adjustment expense payable	196,046	76,829
Change in unearned premium	24,655	30,471
Change in reinsurance, premium and claims payable, excluding restricted cash	(34,052)	11,501
Change in accounts payable and accrued liabilities	5,082	12,593
Stock-based compensation expense	10,017	9,441
Depreciation and amortization expense	13,214	12,894
(Gain) loss on investments	310	(8,086)
Other, net	(18,258)	5,073
<b>Cash provided by operating activities</b>	<b>287,959</b>	<b>314,631</b>
<b>Investing activities</b>		
Sales of available for sale fixed income securities	494,532	132,897
Maturity or call of available for sale fixed income securities	318,558	458,495
Maturity or call of held to maturity fixed income securities	24,950	25,187
Cost of available for sale fixed income securities acquired	(1,243,124)	(1,048,010)
Cost of held to maturity fixed income securities acquired		(115,215)
Cost of other investments acquired	(33,060)	
Change in short-term investments	288,909	328,951
Payments for purchase of businesses, net of cash received	(1,892)	(36,348)
Proceeds from sale of subsidiaries and other investments	2,793	19,855
Other, net	(16,977)	(6,755)
<b>Cash used by investing activities</b>	<b>(165,311)</b>	<b>(240,943)</b>
<b>Financing activities</b>		
Advances on line of credit	210,000	
Payments on line of credit	(15,000)	
Payments on convertible notes		(64,472)
Sale of common stock	36,245	18,639
Purchase of common stock	(303,311)	(11,444)
Dividends paid	(49,301)	(46,532)

Other, net	(6,001)	(1,126)
<b>Cash used by financing activities</b>	<b>(127,368)</b>	<b>(104,935)</b>
Net decrease in cash	(4,720)	(31,247)
Cash at beginning of year	97,857	129,460
<b>Cash at end of period</b>	<b>\$ 93,137</b>	<b>\$ 98,213</b>

See Notes to Consolidated Financial Statements.

8

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**Table of Contents**

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

**(1) General Information**

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

**Basis of Presentation**

Our unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and include the accounts of HCC and its subsidiaries. We have made all adjustments that, in our opinion, are necessary for a fair statement of results of the interim periods, and all such adjustments are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2010. The consolidated balance sheet at December 31, 2010 was derived from the audited financial statements but does not include all disclosures required by GAAP.

Management must make estimates and assumptions that affect amounts reported in our consolidated financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. We have reclassified certain amounts in our 2010 consolidated financial statements to conform to the 2011 presentation. None of our reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

**Recently Issued Accounting Guidance**

A new accounting standard clarifies the definition of acquisition costs incurred by an insurance company and limits capitalization to such costs directly related to renewing or acquiring new insurance contracts. All costs incurred for unsuccessful marketing or underwriting efforts, along with indirect costs, are to be expensed as incurred. We plan to adopt this guidance on January 1, 2012. The new guidance will have no impact on our cash flows, and we do not expect it to have a significant impact on either our expenses or our pretax earnings. However, our adoption of the new standard will result in a reduction of our deferred policy acquisition costs asset, an adjustment to deferred income taxes, and a corresponding decrease in consolidated shareholders' equity. We expect to adopt the new standard retrospectively and estimate that the adjustment to our consolidated shareholders' equity at adoption will be less than \$20.0 million.

New accounting guidance provides a consistent definition of fair value and ensures 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 standard changes 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.

**Table of Contents**

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

A new accounting standard simplifies how entities test goodwill for impairment. The new standard permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. Previous guidance required an entity to test goodwill for impairment, at least on an annual basis, by first comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the new rules, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The new rules are effective on January 1, 2012. Since we perform our annual goodwill impairment test as of June 30 each year, we will first have the option of using the qualitative approach at June 30, 2012. We do not expect application of the new guidance to have a material impact on 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:

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

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

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

Our Level 1 investments 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 approximately 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 at period end. 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 September 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.



**Table of Contents**

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

The following tables present our assets that were measured at fair value at September 30, 2011 and December 31, 2010. No liabilities were measured at fair value at either balance sheet date.

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b><u>September 30, 2011</u></b>				
Fixed income securities available for sale				
U.S. government and government agency securities	\$ 185,530	\$ 107,814		