

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

August 02, 2013

[Table of Contents](#)

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

þ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the Quarterly Period Ended June 30, 2013.  
.. 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  
(State or other jurisdiction of

incorporation or organization)

13403 Northwest Freeway, Houston, Texas  
(Address of principal executive offices)

(713) 690-7300

76-0336636  
(IRS Employer

Identification No.)

77040-6094  
(Zip Code)

(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 þ No ..

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

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 26, 2013, there were approximately 100.1 million shares of common stock outstanding.

**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**

**Table of Contents**

|  | <b>Page</b> |
|--|-------------|
| <b>Part I. FINANCIAL INFORMATION</b>   |             |
| Item 1. Financial Statements (Unaudited)   |             |
| <u>Consolidated Balance Sheets June 30, 2013 and December 31, 2012</u>                                   | 5           |
| <u>Consolidated Statements of Earnings Six and three months ended June 30, 2013 and 2012</u>             | 6           |
| <u>Consolidated Statements of Comprehensive Income Six and three months ended June 30, 2013 and 2012</u> | 7           |
| <u>Consolidated Statement of Changes in Shareholders' Equity Six months ended June 30, 2013</u>          | 8           |
| <u>Consolidated Statements of Cash Flows Six months ended June 30, 2013 and 2012</u>                     | 9           |
| <u>Notes to Consolidated Financial Statements</u>  | 10          |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>     | 25          |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>                                | 43          |
| <u>Item 4. Controls and Procedures</u>   | 43          |
| <b>Part II. OTHER INFORMATION</b>  |             |
| <u>Item 1. Legal Proceedings</u>   | 44          |
| <u>Item 1A. Risk Factors</u>   | 44          |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>                               | 44          |
| <u>Item 3. Defaults Upon Senior Securities</u>   | 44          |
| <u>Item 4. Mine Safety Disclosures</u>   | 44          |
| <u>Item 5. Other Information</u>   | 44          |
| <u>Item 6. Exhibits</u>  | 45          |
| <u>Signatures</u>  | 46          |

**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. These forward-looking statements reflect our current expectations and projections about future events and 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. Generally, words such as anticipate, believe, estimate, expect, intend, plan, probably or similar expressions indicate 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 economic or credit market downturns, including any potential additional ratings downgrade and/or impairment or perceived impairment of the 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,*

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

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

*potential 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,*

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

*changes in our assigned financial strength ratings,*

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

**Table of Contents**

*attraction and retention of qualified employees,*

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

*impairment of goodwill,*

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

*fluctuations in foreign exchange rates,*

*failure of, or loss of security related to, our information technology systems,*

*difficulties with outsourcing relationships, and*

*change of control.*

*We described 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, 2012.*

*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, 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>June 30,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|--|--------------------------|------------------------------|
| <b>ASSETS</b>  |                          |                              |
| Investments  |                          |                              |
| Fixed maturity securities available for sale, at fair value (amortized cost: 2013 and 2012 \$5,856,432)                                      | \$ 6,094,640             | \$ 6,281,781                 |
| Equity securities available for sale, at fair value (cost: 2013 and 2012 \$275,827)  | 347,840                  | 284,639                      |
| Short-term investments, at cost (approximates fair value)  | 216,793                  | 363,053                      |
| Other investments, at fair value (cost: 2013 \$16 and 2012 \$18,391)   | 18                       | 20,925                       |
| <b>Total investments</b>   | <b>6,659,291</b>         | <b>6,950,398</b>             |
| Cash   | 39,353                   | 71,390                       |
| Restricted cash and securities   | 115,031                  | 101,480                      |
| Premium, claims and other receivables  | 648,438                  | 549,725                      |
| Reinsurance recoverables   | 1,086,435                | 1,071,222                    |
| Ceded unearned premium   | 291,939                  | 256,988                      |
| Ceded life and annuity benefits  | 57,841                   | 58,641                       |
| Deferred policy acquisition costs  | 202,322                  | 191,960                      |
| Goodwill   | 885,999                  | 885,860                      |
| Other assets   | 166,845                  | 130,143                      |
| <b>Total assets</b>  | <b>\$ 10,153,494</b>     | <b>\$ 10,267,807</b>         |
| <b>LIABILITIES</b>   |                          |                              |
| Loss and loss adjustment expense payable   | \$ 3,814,684             | \$ 3,767,850                 |
| Life and annuity policy benefits   | 57,841                   | 58,641                       |
| Reinsurance, premium and claims payable  | 337,666                  | 294,621                      |
| Unearned premium   | 1,189,520                | 1,069,956                    |
| Deferred ceding commissions  | 82,119                   | 74,609                       |
| Notes payable  | 639,021                  | 583,944                      |
| Accounts payable and accrued liabilities   | 527,260                  | 875,574                      |
| <b>Total liabilities</b>   | <b>6,648,111</b>         | <b>6,725,195</b>             |
| <b>SHAREHOLDERS' EQUITY</b>  |                          |                              |
| Common stock, \$1.00 par value; 250,000 shares authorized (shares issued: 2013 and 2012 125,114; outstanding: 2013 100,140 and 2012 100,928) | 125,350                  | 125,114                      |

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

|   |                      |                      |
|---|----------------------|----------------------|
| Additional paid-in capital                                    | 1,063,949            | 1,052,253            |
| Retained earnings   | 2,917,086            | 2,756,166            |
| Accumulated other comprehensive income                        | 126,119              | 295,271              |
| Treasury stock, at cost (shares: 2013 25,210 and 2012 24,186) | (727,121)            | (686,192)            |
| <b>Total shareholders' equity</b>                             | <b>3,505,383</b>     | <b>3,542,612</b>     |
| <b>Total liabilities and shareholders' equity</b>             | <b>\$ 10,153,494</b> | <b>\$ 10,267,807</b> |

See Notes to Consolidated Financial Statements.

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

|   | Six months ended June 30, |                   | Three months ended June 30, |                  |
|---|---------------------------|-------------------|-----------------------------|------------------|
|   | 2013                      | 2012              | 2013                        | 2012             |
| <b>REVENUE</b>                                |                           |                   |                             |                  |
| Net earned premium                            | \$ 1,122,542              | \$ 1,112,472      | \$ 561,356                  | \$ 565,331       |
| Net investment income                         | 111,433                   | 110,300           | 55,668                      | 53,290           |
| Other operating income                        | 16,629                    | 12,389            | 7,784                       | 7,188            |
| Net realized investment gain                  | 13,193                    | 7,047             | 4,623                       | 6,876            |
| Other-than-temporary impairment credit losses | -                         | (397)             | -                           | (397)            |
| <b>Total revenue</b>                          | <b>1,263,797</b>          | <b>1,241,811</b>  | <b>629,431</b>              | <b>632,288</b>   |
| <b>EXPENSE</b>                                |                           |                   |                             |                  |
| Loss and loss adjustment expense, net         | 672,171                   | 665,753           | 339,474                     | 336,825          |
| Policy acquisition costs, net                 | 137,745                   | 143,934           | 70,796                      | 74,490           |
| Other operating expense                       | 164,572                   | 167,706           | 87,719                      | 80,424           |
| Interest expense                              | 13,082                    | 13,139            | 6,611                       | 6,230            |
| <b>Total expense</b>                          | <b>987,570</b>            | <b>990,532</b>    | <b>504,600</b>              | <b>497,969</b>   |
| Earnings before income tax expense            | 276,227                   | 251,279           | 124,831                     | 134,319          |
| Income tax expense                            | 82,215                    | 75,202            | 36,669                      | 40,826           |
| <b>Net earnings</b>                           | <b>\$ 194,012</b>         | <b>\$ 176,077</b> | <b>\$ 88,162</b>            | <b>\$ 93,493</b> |
| <b>Earnings per common share</b>              |                           |                   |                             |                  |
| Basic   | \$ 1.93                   | \$ 1.71           | \$ 0.88                     | \$ 0.92          |
| Diluted                                       | \$ 1.92                   | \$ 1.71           | \$ 0.87                     | \$ 0.92          |

See Notes to Consolidated Financial Statements.

**Table of Contents****HCC Insurance Holdings, Inc. and Subsidiaries****Consolidated Statements of Comprehensive Income****(unaudited, in thousands)**

|   | <b>Six months ended June 30,</b> |                   | <b>Three months ended June 30,</b> |                   |
|---|----------------------------------|-------------------|------------------------------------|-------------------|
|   | <b>2013</b>                      | <b>2012</b>       | <b>2013</b>                        | <b>2012</b>       |
| Net earnings  | \$ 194,012                       | \$ 176,077        | \$ 88,162                          | \$ 93,493         |
| Other comprehensive income (loss)                   |                                  |                   |                                    |                   |
| Investment gains (losses):                          |                                  |                   |                                    |                   |
| Investment gains (losses) during the period         | (247,429)                        | 61,313            | (217,034)                          | 39,673            |
| Income tax charge (benefit)                         | (87,443)                         | 21,804            | (77,116)                           | 14,501            |
| Investment gains (losses), net of tax               | (159,986)                        | 39,509            | (139,918)                          | 25,172            |
| Less reclassification adjustments for:              |                                  |                   |                                    |                   |
| Gains included in net earnings                      | 13,193                           | 6,659             | 4,623                              | 6,488             |
| Income tax charge                                   | 4,618                            | 2,331             | 1,619                              | 2,271             |
| Gains included in net earnings, net of tax          | 8,575                            | 4,328             | 3,004                              | 4,217             |
| Net unrealized investment gains (losses)            | (168,561)                        | 35,181            | (142,922)                          | 20,955            |
| Foreign currency translation adjustment             | (1,145)                          | (3,313)           | 911                                | (5,846)           |
| Income tax benefit                                  | (554)                            | (249)             | (30)                               | (372)             |
| Foreign currency translation adjustment, net of tax | (591)                            | (3,064)           | 941                                | (5,474)           |
| Other comprehensive income (loss)                   | (169,152)                        | 32,117            | (141,981)                          | 15,481            |
| <b>Comprehensive income (loss)</b>                  | <b>\$ 24,860</b>                 | <b>\$ 208,194</b> | <b>\$ (53,819)</b>                 | <b>\$ 108,974</b> |

See Notes to Consolidated Financial Statements.

**Table of Contents****HCC Insurance Holdings, Inc. and Subsidiaries****Consolidated Statement of Changes in Shareholders' Equity****Six months ended June 30, 2013****(unaudited, in thousands except per share data)**

|   | <b>Common<br/>stock</b> | <b>Additional<br/>paid-in<br/>capital</b> | <b>Retained<br/>earnings</b> | <b>Accumulated<br/>other<br/>comprehensive<br/>income</b> | <b>Treasury<br/>stock</b> | <b>Total<br/>shareholders<br/>equity</b> |
|---|-------------------------|---|------------------------------|---|---------------------------|--|
| <b>Balance at December 31, 2012</b>                                     | \$ 125,114              | \$ 1,052,253                              | \$ 2,756,166                 | \$ 295,271  | \$ (686,192)              | \$ 3,542,612                             |
| Net earnings  | -                       | -   | 194,012                      | -   | -                         | 194,012                                  |
| Other comprehensive loss  | -                       | -   | -                            | (169,152)   | -                         | (169,152)                                |
| Issuance of 250 shares for exercise of<br>options, including tax effect | 250                     | 7,158                                     | -                            | -   | -                         | 7,408                                    |
| Purchase of 1,024 common shares   | -                       | -   | -                            | -   | (40,929)                  | (40,929)                                 |
| Stock-based compensation  | (14)                    | 4,538                                     | -                            | -   | -                         | 4,524                                    |
| Cash dividends declared, \$0.33 per share                               | -                       | -   | (33,092)                     | -   | -                         | (33,092)                                 |
| <b>Balance at June 30, 2013</b>   | \$ 125,350              | \$ 1,063,949                              | \$ 2,917,086                 | \$ 126,119  | \$ (727,121)              | \$ 3,505,383                             |

See Notes to Consolidated Financial Statements.

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

|   | Six months ended June 30,<br>2013 | 2012             |
|---|-----------------------------------|------------------|
| <b>Operating activities</b>   |                                   |                  |
| Net earnings  | \$ 194,012                        | \$ 176,077       |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                                   |                  |
| Change in premium, claims and other receivables                                     | (99,897)                          | (68,083)         |
| Change in reinsurance recoverables  | (17,018)                          | 2,921            |
| Change in ceded unearned premium  | (35,032)                          | (32,951)         |
| Change in loss and loss adjustment expense payable                                  | 52,026                            | 84,925           |
| Change in unearned premium  | 119,759                           | 116,448          |
| Change in reinsurance, premium and claims payable, excluding restricted cash        | 43,237                            | 3,290            |
| Change in accounts payable and accrued liabilities                                  | (119,103)                         | (44,867)         |
| Stock-based compensation expense  | 6,955                             | 6,168            |
| Depreciation and amortization expense   | 9,093                             | 9,133            |
| Gain on investments   | (13,193)                          | (6,650)          |
| Other, net  | (38,849)                          | (1,860)          |
| <b>Cash provided by operating activities</b>  | <b>101,990</b>                    | <b>244,551</b>   |
| <b>Investing activities</b>   |                                   |                  |
| Sales of available for sale fixed maturity securities                               | 171,801                           | 218,572          |
| Sales of equity securities  | 44,308                            | 1,739            |
| Sales of other investments  | 23,719                            | -                |
| Maturity or call of available for sale fixed maturity securities                    | 375,924                           | 325,046          |
| Maturity or call of held to maturity fixed maturity securities                      | -                                 | 28,579           |
| Cost of available for sale fixed maturity securities acquired                       | (756,782)                         | (628,278)        |
| Cost of equity securities acquired  | (114,685)                         | (94,706)         |
| Change in short-term investments  | 145,977                           | (62,621)         |
| Payments for purchase of businesses, net of cash received                           | (8,214)                           | (32,143)         |
| Other, net  | (2,191)                           | (6,982)          |
| <b>Cash used by investing activities</b>  | <b>(120,143)</b>                  | <b>(250,794)</b> |
| <b>Financing activities</b>   |                                   |                  |
| Advances on line of credit  | 70,000                            | 140,000          |
| Payments on line of credit  | (15,000)                          | (28,000)         |
| Sale of common stock  | 7,408                             | 13,644           |
| Purchase of common stock  | (46,586)                          | (126,442)        |
| Dividends paid  | (33,250)                          | (32,002)         |
| Other, net  | 3,544                             | (2,323)          |
| <b>Cash used by financing activities</b>  | <b>(13,884)</b>                   | <b>(35,123)</b>  |

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

|                              |                  |                  |
|------------------------------|------------------|------------------|
| Net decrease in cash         | (32,037)         | (41,366)         |
| Cash at beginning of year    | 71,390           | 104,550          |
| <b>Cash at end of period</b> | <b>\$ 39,353</b> | <b>\$ 63,184</b> |

See Notes to Consolidated Financial Statements.

**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 largely non-correlated specialty insurance products, including property and casualty, accident and health, surety and credit product lines, in approximately 180 countries. We market our products through a network of independent agents and brokers, through managing general agents owned by the company, and directly to customers. In addition, we assume insurance written by other insurance companies.

**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, 2012. The consolidated balance sheet at December 31, 2012 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.

**Goodwill**

An indicator of impairment of goodwill exists when the fair value of a reporting unit is less than its carrying value. We conducted our annual goodwill impairment test as of June 30, 2013, which is consistent with the timeframe for our annual assessment in prior years. Based on our determination of the fair value of each of our five reporting units, the fair value of each reporting unit exceeded its carrying amount as of June 30, 2013.

**(2) Investments**

The cost or amortized cost, gross unrealized gain or loss, and fair value of our available for sale fixed maturity and equity securities were as follows:

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair value |
|--|------------------------------|-----------------------------|-----------------------------|------------|
| <b>June 30, 2013</b>   |                              |                             |                             |            |
| U.S. government and government agency securities                                   | \$ 120,951                   | \$ 3,076                    | \$ (363)                    | \$ 123,664 |
| Fixed maturity securities of states, municipalities and political subdivisions     | 974,153                      | 60,281                      | (4,617)                     | 1,029,817  |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 2,218,302                    | 91,093                      | (37,775)                    | 2,271,620  |
| Corporate securities   | 1,215,761                    | 34,077                      | (13,193)                    | 1,236,645  |
| Residential mortgage-backed securities   | 601,437                      | 17,204                      | (13,146)                    | 605,495    |
| Commercial mortgage-backed securities  | 529,714                      | 19,377                      | (12,892)                    | 536,199    |
| Asset-backed securities  | 54,478                       | 219                         | (406)                       | 54,291     |

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

|  |                     |                   |                    |                     |
|--|---------------------|-------------------|--------------------|---------------------|
| Foreign government securities          | 228,364             | 9,755             | (1,210)            | 236,909             |
| <b>Total fixed maturity securities</b> | <b>\$ 5,943,160</b> | <b>\$ 235,082</b> | <b>\$ (83,602)</b> | <b>\$ 6,094,640</b> |
| <b>Equity securities</b>               | <b>\$ 323,249</b>   | <b>\$ 31,169</b>  | <b>\$ (6,578)</b>  | <b>\$ 347,840</b>   |

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

|  | Cost or<br>amortized<br>cost | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair value          |
|--|------------------------------|-----------------------------|-----------------------------|---------------------|
| <b>December 31, 2012</b>   |                              |                             |                             |                     |
| U.S. government and government agency securities                                   | \$ 195,049                   | \$ 4,560                    | \$ (2)                      | \$ 199,607          |
| Fixed maturity securities of states, municipalities and political subdivisions     | 969,966                      | 96,027                      | (182)                       | 1,065,811           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 2,033,947                    | 168,772                     | (2,388)                     | 2,200,331           |
| Corporate securities   | 1,247,282                    | 69,243                      | (1,355)                     | 1,315,170           |
| Residential mortgage-backed securities   | 632,665                      | 32,560                      | (338)                       | 664,887             |
| Commercial mortgage-backed securities  | 482,808                      | 41,748                      | (267)                       | 524,289             |
| Asset-backed securities  | 32,801                       | 474                         | -                           | 33,275              |
| Foreign government securities  | 261,914                      | 16,515                      | (18)                        | 278,411             |
| <b>Total fixed maturity securities</b>   | <b>\$ 5,856,432</b>          | <b>\$ 429,899</b>           | <b>\$ (4,550)</b>           | <b>\$ 6,281,781</b> |
| <b>Equity securities</b>   | <b>\$ 275,827</b>            | <b>\$ 13,768</b>            | <b>\$ (4,956)</b>           | <b>\$ 284,639</b>   |

Substantially all of our fixed maturity securities are investment grade. The following table displays the gross unrealized losses and fair value of all available for sale 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 |
| <b>June 30, 2013</b>   |                     |                   |                   |                   |            |                   |
| <b>Fixed maturity securities</b>   |                     |                   |                   |                   |            |                   |
| U.S. government and government agency securities                                   | \$ 20,667           | \$ (363)          | \$ -              | \$ -              | \$ 20,667  | \$ (363)          |
| Fixed maturity securities of states, municipalities and political subdivisions     | 97,408              | (4,617)           | -                 | -                 | 97,408     | (4,617)           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 648,672             | (37,753)          | 1,197             | (22)              | 649,869    | (37,775)          |
| Corporate securities   | 419,283             | (12,406)          | 12,534            | (787)             | 431,817    | (13,193)          |
| Residential mortgage-backed securities   | 278,062             | (13,146)          | -                 | -                 | 278,062    | (13,146)          |
| Commercial mortgage-backed securities  | 224,294             | (12,892)          | -                 | -                 | 224,294    | (12,892)          |
| Asset-backed securities  | 18,066              | (406)             | -                 | -                 | 18,066     | (406)             |
| Foreign government securities  | 67,832              | (1,210)           | -                 | -                 | 67,832     | (1,210)           |
| Equity securities  | 98,086              | (6,237)           | 2,832             | (341)             | 100,918    | (6,578)           |

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

|              |              |             |           |            |              |             |
|--------------|--------------|-------------|-----------|------------|--------------|-------------|
| <b>Total</b> | \$ 1,872,370 | \$ (89,030) | \$ 16,563 | \$ (1,150) | \$ 1,888,933 | \$ (90,180) |
|--------------|--------------|-------------|-----------|------------|--------------|-------------|

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

|  | <b>Less than 12 months</b> |                          | <b>12 months or more</b> |                          | <b>Total</b>      |                          |
|--|----------------------------|--------------------------|--------------------------|--------------------------|-------------------|--------------------------|
|  | <b>Fair value</b>          | <b>Unrealized losses</b> | <b>Fair value</b>        | <b>Unrealized losses</b> | <b>Fair value</b> | <b>Unrealized losses</b> |
| <b>December 31, 2012</b>   |                            |                          |                          |                          |                   |                          |
| Fixed maturity securities  |                            |                          |                          |                          |                   |                          |
| U.S. government and government agency securities                                   | \$ 55,034                  | \$ (2)                   | \$ -                     | \$ -                     | \$ 55,034         | \$ (2)                   |
| Fixed maturity securities of states, municipalities and political subdivisions     | 14,162                     | (182)                    | -                        | -                        | 14,162            | (182)                    |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 155,902                    | (2,388)                  | -                        | -                        | 155,902           | (2,388)                  |
| Corporate securities   | 85,245                     | (1,220)                  | 2,616                    | (135)                    | 87,861            | (1,355)                  |
| Residential mortgage-backed securities   | 49,486                     | (338)                    | -                        | -                        | 49,486            | (338)                    |
| Commercial mortgage-backed securities  | 26,263                     | (267)                    | -                        | -                        | 26,263            | (267)                    |
| Foreign government securities  | 7,007                      | (18)                     | -                        | -                        | 7,007             | (18)                     |
| Equity securities  | 103,647                    | (4,956)                  | -                        | -                        | 103,647           | (4,956)                  |
| <b>Total</b>   | <b>\$ 496,746</b>          | <b>\$ (9,371)</b>        | <b>\$ 2,616</b>          | <b>\$ (135)</b>          | <b>\$ 499,362</b> | <b>\$ (9,506)</b>        |

A security has an impairment loss when its fair value is less than its cost or amortized cost at the balance sheet date. We evaluate our securities 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. We recognized no other-than-temporary impairment losses in the first six months of 2013 and \$0.4 million in the first six months and second quarter of 2012.

We do not consider the \$90.2 million of gross unrealized losses on fixed maturity and equity securities in our portfolio at June 30, 2013 to be other-than-temporary impairments because: 1) as of June 30, 2013, we have received substantially all contractual interest and principal payments on the fixed maturity securities, 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 or cost bases and 4) the unrealized loss primarily relates to non-credit factors, such as interest rate changes and market conditions that occurred in the second quarter of 2013.

The amortized cost and fair value of our fixed maturity securities at June 30, 2013, 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 6.2 years at June 30, 2013.

|                                     | <b>Cost or<br/>amortized cost</b> | <b>Fair value</b> |
|-------------------------------------|-----------------------------------|-------------------|
| Due in 1 year or less               | \$ 217,012                        | \$ 219,433        |
| Due after 1 year through 5 years    | 1,062,230                         | 1,098,261         |
| Due after 5 years through 10 years  | 1,456,485                         | 1,524,386         |
| Due after 10 years through 15 years | 1,020,759                         | 1,045,896         |
| Due after 15 years                  | 1,001,045                         | 1,010,679         |

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

|   |                     |                     |
|---|---------------------|---------------------|
| Securities with contractual maturities      | 4,757,531           | 4,898,655           |
| Mortgage-backed and asset-backed securities | 1,185,629           | 1,195,985           |
| <b>Total fixed maturity securities</b>      | <b>\$ 5,943,160</b> | <b>\$ 6,094,640</b> |

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

The sources of net investment income were as follows:

|                                 | Six months ended June 30, |                   | Three months ended June 30, |                  |
|---------------------------------|---------------------------|-------------------|-----------------------------|------------------|
|                                 | 2013                      | 2012              | 2013                        | 2012             |
| Fixed maturity securities       |                           |                   |                             |                  |
| Taxable                         | \$ 51,022                 | \$ 58,218         | \$ 25,062                   | \$ 27,103        |
| Exempt from U.S. income taxes   | 56,075                    | 52,872            | 28,186                      | 26,260           |
| Total fixed maturity securities | 107,097                   | 111,090           | 53,248                      | 53,363           |
| Equity securities               | 7,808                     | 993               | 4,228                       | 993              |
| Short-term investments          | 80                        | 102               | 68                          | 40               |
| Other investment income         | 319                       | 868               | 366                         | 401              |
| Total investment income         | 115,304                   | 113,053           | 57,910                      | 54,797           |
| Investment expense              | (3,871)                   | (2,753)           | (2,242)                     | (1,507)          |
| <b>Net investment income</b>    | <b>\$ 111,433</b>         | <b>\$ 110,300</b> | <b>\$ 55,668</b>            | <b>\$ 53,290</b> |

**(3) Derivative Financial Instrument**

We utilize the British pound sterling and the Euro as the functional currency in certain of our foreign operations. As a result, we have exposure to fluctuations in exchange rates between these currencies and the U.S. dollar. From time to time, we may use derivative instruments to protect our investment in these foreign operations by limiting our exposure to fluctuations in exchange rates.

In 2012, we entered into a forward contract to sell 45.0 million Euros for U.S. dollars in September 2013. Through June 30, 2013, this transaction was designated and qualified as a hedge of a portion of our net investment in a subsidiary that has the Euro as its functional currency. Changes in the fair value of the forward contract, net of the related deferred income tax effect, were recognized in our foreign currency translation adjustment, which is a component of accumulated other comprehensive income. This amount offset changes in the value of the net investment being hedged, as the cumulative translation adjustment related to the foreign subsidiary, representing the effect of translating the subsidiary's assets and liabilities from Euros to U.S. dollars, is also reported in our foreign currency translation adjustment.

The fair value of the forward contract was a liability of \$2.3 million at June 30, 2013, compared to \$3.2 million at December 31, 2012. The liability is reported in accounts payable and accrued liabilities in our consolidated balance sheets. At inception of the hedge and quarterly thereafter through June 30, 2013, we assessed whether the hedge transaction was effective. Any ineffectiveness would have been recognized immediately as other operating expense in our consolidated statements of earnings. There was no ineffectiveness on the forward contract during 2013 or 2012.

In July 2013, we entered into a forward contract to buy 45.0 million Euros for U.S. dollars in September 2013, effectively offsetting the contract entered into in 2012. Beginning in July 2013, we have discontinued hedge accounting and any subsequent changes in the fair value of the two forward contracts will be recognized in our consolidated statements of earnings. Because the contracts offset, the net change in fair value and the impact on pretax earnings, if any, should be immaterial in the third quarter of 2013.



**Table of Contents**

**HCC Insurance Holdings, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(unaudited, tables in thousands except per share data)**

**(4) Fair Value Measurements**

Our financial instruments include assets and liabilities carried at fair value, as well as assets and liabilities carried at cost or amortized cost but disclosed at fair value in our financial statements. 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, money market funds 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 maturity securities, which consist of U.S. government agency securities, municipal bonds (including those held as restricted securities), corporate debt securities, bank loans, mortgage-backed and asset-backed securities (including collateralized loan obligations), and deposits supporting our Lloyd's syndicate business. Level 2 also includes certificates of deposit and other interest-bearing deposits at banks, which we report as short-term investments, and a forward contract, which hedges our net investment in a Euro-functional currency foreign subsidiary. 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 are responsible for the prices used in our fair value measurements. 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 managers and Lloyd's of London 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, third party investment managers or Lloyd's of London as of June 30, 2013 or December 31, 2012.

Our Level 2 financial instruments also include our notes payable. We determine the fair value of our 6.30% Senior Notes based on quoted prices, but the market is inactive. The fair value of borrowings under our Revolving Loan Facility approximates the carrying amount because interest is based on 30-day LIBOR plus a margin.

Our Level 3 securities include certain fixed maturity securities and an insurance contract that we account for as a derivative and classify in other assets. This category also includes a liability for future earnout payments due to former owners of a business we acquired, which is classified within accounts payable and accrued liabilities. Fixed maturity securities classified as Level 3 are primarily special purpose revenue bond auction rate securities. The interest rates on these securities are reset through auctions at periodic intervals. These securities are thinly traded and observable market data is not readily available. We determine the fair value of these securities using prices quoted by a broker. We determine

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

fair value of our other Level 3 assets and liabilities based on internally developed models that use assumptions or other data that are not readily observable from objective sources.

**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 the fair value of our financial instruments that were carried or disclosed at fair value. Unless indicated, these items were carried at fair value on our consolidated balance sheet.

|  | Level 1           | Level 2             | Level 3          | Total               |
|--|-------------------|---------------------|------------------|---------------------|
| <b>June 30, 2013</b>   |                   |                     |                  |                     |
| Fixed maturity securities  |                   |                     |                  |                     |
| U.S. government and government agency securities                                   | \$ 103,294        | \$ 20,370           | \$ -             | \$ 123,664          |
| Fixed maturity securities of states, municipalities and political subdivisions     | -                 | 1,029,817           | -                | 1,029,817           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | -                 | 2,262,343           | 9,277            | 2,271,620           |
| Corporate securities   | -                 | 1,236,476           | 169              | 1,236,645           |
| Residential mortgage-backed securities   | -                 | 605,495             | -                | 605,495             |
| Commercial mortgage-backed securities  | -                 | 536,199             | -                | 536,199             |
| Asset-backed securities  | -                 | 54,291              | -                | 54,291              |
| Foreign government securities  | -                 | 236,909             | -                | 236,909             |
| Total fixed maturity securities  | 103,294           | 5,981,900           | 9,446            | 6,094,640           |
| Equity securities  | 347,840           | -                   | -                | 347,840             |
| Short-term investments*  | 115,965           | 100,828             | -                | 216,793             |
| Other investments  | 18                | -                   | -                | 18                  |
| Restricted cash and securities   | -                 | 1,848               | -                | 1,848               |
| Premium, claims and other receivables  | -                 | 62,118              | -                | 62,118              |
| Other assets   | -                 | -                   | 589              | 589                 |
| <b>Total assets measured at fair value</b>   | <b>\$ 567,117</b> | <b>\$ 6,146,694</b> | <b>\$ 10,035</b> | <b>\$ 6,723,846</b> |
| Notes payable*   | \$ -              | \$ 688,240          | \$ -             | \$ 688,240          |
| Accounts payable and accrued liabilities - forward contract                        | -                 | 2,283               | -                | 2,283               |
| Accounts payable and accrued liabilities - earnout liability                       | -                 | 1,848               | 7,133            | 8,981               |
| <b>Total liabilities measured at fair value</b>                                    | <b>\$ -</b>       | <b>\$ 692,371</b>   | <b>\$ 7,133</b>  | <b>\$ 699,504</b>   |

\* Carried at cost or amortized cost on our consolidated balance sheet.

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

|  | Level 1           | Level 2             | Level 3         | Total               |
|--|-------------------|---------------------|-----------------|---------------------|
| <b>December 31, 2012</b>   |                   |                     |                 |                     |
| Fixed maturity securities  |                   |                     |                 |                     |
| U.S. government and government agency securities                                   | \$ 174,520        | \$ 25,087           | \$ -            | \$ 199,607          |
| Fixed maturity securities of states, municipalities and political subdivisions     | -                 | 1,065,811           | -               | 1,065,811           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | -                 | 2,200,331           | -               | 2,200,331           |
| Corporate securities   | -                 | 1,315,006           | 164             | 1,315,170           |
| Residential mortgage-backed securities   | -                 | 664,887             | -               | 664,887             |
| Commercial mortgage-backed securities  | -                 | 524,289             | -               | 524,289             |
| Asset-backed securities  | -                 | 33,275              | -               | 33,275              |
| Foreign government securities  | -                 | 278,411             | -               | 278,411             |
| Total fixed maturity securities  | 174,520           | 6,107,097           | 164             | 6,281,781           |
| Equity securities  | 284,639           | -                   | -               | 284,639             |
| Short-term investments*  | 251,988           | 111,065             | -               | 363,053             |
| Other investments  | 20,925            | -                   | -               | 20,925              |
| Restricted cash and securities   | -                 | 2,043               | -               | 2,043               |
| Premium, claims and other receivables  | -                 | 68,207              | -               | 68,207              |
| Other assets   | -                 | -                   | 349             | 349                 |
| <b>Total assets measured at fair value</b>   | <b>\$ 732,072</b> | <b>\$ 6,288,412</b> | <b>\$ 513</b>   | <b>\$ 7,020,997</b> |
| Notes payable*   | \$ -              | \$ 636,363          | \$ -            | \$ 636,363          |
| Accounts payable and accrued liabilities - forward contract                        | -                 | 3,194               | -               | 3,194               |
| Accounts payable and accrued liabilities - earnout liability                       | -                 | 2,043               | 7,009           | 9,052               |
| <b>Total liabilities measured at fair value</b>                                    | <b>\$ -</b>       | <b>\$ 641,600</b>   | <b>\$ 7,009</b> | <b>\$ 648,609</b>   |

\*Carried at cost or amortized cost on our consolidated balance sheet.

**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 the changes in fair value of our Level 3 financial instruments.

|                                   | 2013                            |                 |                  | 2012   |                                 |                 |                 |
|-----------------------------------|---------------------------------|-----------------|------------------|--|---------------------------------|-----------------|-----------------|
|                                   | Fixed<br>maturity<br>securities | Other<br>assets | Total<br>assets  | Accounts<br>payable<br>and<br>accrued<br>liabilities | Fixed<br>maturity<br>securities | Other<br>assets | Total<br>assets |
| Balance at beginning of year      | \$ 164                          | \$ 349          | \$ 513           | \$ 7,009   | \$ 1,170                        | \$ 1,516        | \$ 2,686        |
| Purchases                         | 9,430                           | -               | 9,430            | -  | -                               | -               | -               |
| Gains reported in:                |                                 |                 |                  |  |                                 |                 |                 |
| Net earnings                      | 6                               | 110             | 116              | 62   | -                               | 215             | 215             |
| Other comprehensive income        | 15                              | -               | 15               | -  | 2                               | -               | 2               |
| Transfers out of Level 3          | -                               | -               | -                | -  | (1,015)                         | -               | (1,015)         |
| <b>Balance at March 31</b>        | <b>9,615</b>                    | <b>459</b>      | <b>10,074</b>    | <b>7,071</b>   | <b>157</b>                      | <b>1,731</b>    | <b>1,888</b>    |
| Gains (losses) reported in:       |                                 |                 |                  |  |                                 |                 |                 |
| Net earnings                      | 15                              | 130             | 145              | 62   | (1)                             | 116             | 115             |
| Other comprehensive income (loss) | (184)                           | -               | (184)            | -  | 3                               | -               | 3               |
| <b>Balance at June 30</b>         | <b>\$ 9,446</b>                 | <b>\$ 589</b>   | <b>\$ 10,035</b> | <b>\$ 7,133</b>                                      | <b>\$ 159</b>                   | <b>\$ 1,847</b> | <b>\$ 2,006</b> |

There were no transfers between Level 1, Level 2 or Level 3 in 2013. We transferred an investment from Level 3 to Level 2 in 2012 because we were able to determine its fair value using inputs based on observable market data in the period transferred.

**(5) Reinsurance**

In the normal course of business, our insurance companies cede a portion of their premium to reinsurers through treaty and facultative reinsurance agreements. Although reinsurance 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 losses 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, |                   |
|----------------------------|---------------------------|---------------------|-----------------------------|-------------------|
|                            | 2013                      | 2012                | 2013                        | 2012              |
| Direct written premium     | \$ 1,294,681              | \$ 1,222,766        | \$ 713,110                  | \$ 677,996        |
| Reinsurance assumed        | 234,967                   | 251,476             | 96,333                      | 113,557           |
| Reinsurance ceded          | (321,430)                 | (273,750)           | (180,409)                   | (149,465)         |
| <b>Net written premium</b> | <b>\$ 1,208,218</b>       | <b>\$ 1,200,492</b> | <b>\$ 629,034</b>           | <b>\$ 642,088</b> |

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

|                       |              |              |            |            |
|-----------------------|--------------|--------------|------------|------------|
| Direct earned premium | \$ 1,237,629 | \$ 1,193,537 | \$ 621,224 | \$ 602,354 |
| Reinsurance assumed   | 171,308      | 168,882      | 86,036     | 86,544     |
| Reinsurance ceded     | (286,395)    | (249,947)    | (145,904)  | (123,567)  |

|                           |              |              |            |            |
|---------------------------|--------------|--------------|------------|------------|
| <b>Net earned premium</b> | \$ 1,122,542 | \$ 1,112,472 | \$ 561,356 | \$ 565,331 |
|---------------------------|--------------|--------------|------------|------------|

|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Direct loss and loss adjustment expense | \$ 693,480 | \$ 727,921 | \$ 335,968 | \$ 362,529 |
| Reinsurance assumed                     | 110,708    | 61,035     | 71,017     | 24,326     |
| Reinsurance ceded                       | (132,017)  | (123,203)  | (67,511)   | (50,030)   |

|   |            |            |            |            |
|---|------------|------------|------------|------------|
| <b>Net loss and loss adjustment expense</b> | \$ 672,171 | \$ 665,753 | \$ 339,474 | \$ 336,825 |
|---|------------|------------|------------|------------|

**Table of Contents****HCC Insurance Holdings, Inc. and Subsidiaries****Notes to Consolidated Financial Statements**

(unaudited, tables in thousands except per share data)

|                                     | Six months ended June 30, |                   | Three months ended June 30, |                  |
|-------------------------------------|---------------------------|-------------------|-----------------------------|------------------|
|                                     | 2013                      | 2012              | 2013                        | 2012             |
| Policy acquisition costs            | \$ 204,031                | \$ 198,156        | \$ 103,745                  | \$ 102,421       |
| Ceding commissions                  | (66,286)                  | (54,222)          | (32,949)                    | (27,931)         |
| <b>Net policy acquisition costs</b> | <b>\$ 137,745</b>         | <b>\$ 143,934</b> | <b>\$ 70,796</b>            | <b>\$ 74,490</b> |

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

|   | June 30,<br>2013    | December 31,<br>2012 |
|---|---------------------|----------------------|
| Reinsurance recoverable on paid losses                      | \$ 84,272           | \$ 54,675            |
| Reinsurance recoverable on outstanding losses               | 457,227             | 479,026              |
| Reinsurance recoverable on incurred but not reported losses | 546,436             | 539,021              |
| Reserve for uncollectible reinsurance                       | (1,500)             | (1,500)              |
| <b>Total reinsurance recoverables</b>                       | <b>\$ 1,086,435</b> | <b>\$ 1,071,222</b>  |

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 available to us as collateral, plus other potential offsets at June 30, 2013 and December 31, 2012.

|                        | June 30,<br>2013  | December 31,<br>2012 |
|------------------------|-------------------|----------------------|
| Payables to reinsurers | \$ 208,483        | \$ 190,228           |
| Letters of credit      | 87,033            | 89,832               |
| Cash                   | 89,469            | 116,597              |
| <b>Total credits</b>   | <b>\$ 384,985</b> | <b>\$ 396,657</b>    |

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

|   | June 30,<br>2013 | December 31,<br>2012 |
|---|------------------|----------------------|
| Loss and loss adjustment expense payable      | \$ 3,814,684     | \$ 3,767,850         |
| Reinsurance recoverable on outstanding losses | (457,227)        | (479,026)            |

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

|   |                     |                     |
|---|---------------------|---------------------|
| Reinsurance recoverable on incurred but not reported losses | (546,436)           | (539,021)           |
| <b>Net reserves</b>   | <b>\$ 2,811,021</b> | <b>\$ 2,749,803</b> |
| Unearned premium  | \$ 1,189,520        | \$ 1,069,956        |
| Ceded unearned premium                                      | (291,939)           | (256,988)           |
| <b>Net unearned premium</b>                                 | <b>\$ 897,581</b>   | <b>\$ 812,968</b>   |
| Deferred policy acquisition costs                           | \$ 202,322          | \$ 191,960          |
| Deferred ceding commissions                                 | (82,119)            | (74,609)            |
| <b>Net deferred policy acquisition costs</b>                | <b>\$ 120,203</b>   | <b>\$ 117,351</b>   |

**Table of Contents****HCC Insurance Holdings, Inc. and Subsidiaries****Notes to Consolidated Financial Statements****(unaudited, tables in thousands except per share data)****(6) Liability for Unpaid Loss and Loss Adjustment Expense**

In the first six months and second quarter of 2013, we recognized favorable net loss development of \$9.5 million in our U.S. Surety & Credit segment and \$2.3 million in our International segment, resulting from our quarterly review of reserves. Our second quarter review indicated that continued lower than expected claims activity related to older underwriting years was contributing to a growing redundancy in our U.S. Surety & Credit segment. As a result, we recognized favorable net development of \$3.7 million and \$5.8 million for our surety and credit lines of business, respectively, related to the 2010 and prior underwriting years. In the International segment, we released prior year catastrophe reserves related to the 2010 New Zealand earthquake, due to settlement of these claims in 2013. We recognized no loss development in the first six months or second quarter of 2012.

A recent ruling against another insurance company by the Spanish supreme court regarding a specific class of Spanish surety bonds, which are similar to those written by our Spanish subsidiary, may result in an increase in our recorded loss reserves for surety claims in our International segment. At the present time, it is not possible for us to determine the impact, if any, on our recorded reserves until we complete our analysis of the applicability of this ruling to our bonds. The court's ruling is expected to be published in the third quarter of 2013.

**(7) Notes Payable**

Our notes payable consisted of the following:

|   | <b>June 30,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|---|--------------------------|------------------------------|
| 6.30% Senior Notes                      | \$ 299,021               | \$ 298,944                   |
| \$600.0 million Revolving Loan Facility | 340,000                  | 285,000                      |
| <b>Total notes payable</b>              | <b>\$ 639,021</b>        | <b>\$ 583,944</b>            |

On April 26, 2013, we entered into an agreement to modify our \$600.0 million Revolving Loan Facility (the Facility). Under the amended agreement, the Facility expires on April 26, 2017. The new borrowing rate is LIBOR plus 125 basis points with a commitment fee of 15 basis points. The weighted-average interest rate on borrowings under the Facility at June 30, 2013 was 1.44%. The borrowings and letters of credit issued under the Facility reduced our available borrowing capacity on the Facility to \$253.6 million at June 30, 2013.

There have been no changes to the terms and conditions related to our Senior Notes or the Standby Letter of Credit Facility (Standby Facility) from those described in Note 7, Notes Payable to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2012.

We were in compliance with debt covenants related to our 6.30% Senior Notes, the Facility and the Standby Facility at June 30, 2013.

**Table of Contents****HCC Insurance Holdings, Inc. and Subsidiaries****Notes to Consolidated Financial Statements****(unaudited, tables in thousands except per share data)****(8) Accumulated Other Comprehensive Income**

The components of accumulated other comprehensive income in our consolidated balance sheets were as follows:

|                                   | Net<br>unrealized<br>investment<br>gains (losses) | Foreign<br>currency<br>translation<br>adjustment | Accumulated<br>other<br>comprehensive<br>income |
|-----------------------------------|---|--|---|
| Balance at December 31, 2012      | \$ 282,503  | \$ 12,768  | \$ 295,271                                      |
| Other comprehensive loss          | (25,639)  | (1,532)  | (27,171)  |
| <b>Balance at March 31, 2013</b>  | <b>256,864</b>                                    | <b>11,236</b>                                    | <b>268,100</b>                                  |
| Other comprehensive income (loss) | (142,922)   | 941  | (141,981)                                       |
| <b>Balance at June 30, 2013</b>   | <b>\$ 113,942</b>                                 | <b>\$ 12,177</b>                                 | <b>\$ 126,119</b>                               |

The reductions in net unrealized investment gains (losses) during 2013, shown in the table above, included reclassifications of amounts into net earnings. The reclassifications recorded in our consolidated statements of earnings were as follows:

|                                | Six months<br>ended<br>June 30, 2013 | Three months<br>ended<br>June 30, 2013 |
|--------------------------------|--------------------------------------|--|
| Net realized investment gain   | \$ 13,193                            | \$ 4,623                               |
| Income tax expense             | 4,618                                | 1,619                                  |
| <b>Total reclassifications</b> | <b>\$ 8,575</b>                      | <b>\$ 3,004</b>                        |

**(9) 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,

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

|  | 2013              | 2012              | 2013             | 2012             |
|--|-------------------|-------------------|------------------|------------------|
| Net earnings   | \$ 194,012        | \$ 176,077        | \$ 88,162        | \$ 93,493        |
| Less: net earnings attributable to unvested restricted stock                       | (3,227)           | (3,238)           | (1,445)          | (1,775)          |
| <b>Net earnings available to common stock</b>                                      | <b>\$ 190,785</b> | <b>\$ 172,839</b> | <b>\$ 86,717</b> | <b>\$ 91,718</b> |
| Weighted-average common shares outstanding   | 98,965            | 100,802           | 98,870           | 99,563           |
| Dilutive effect of outstanding securities (determined using treasury stock method) | 245               | 181               | 251              | 288              |
| <b>Weighted-average common shares and potential common shares outstanding</b>      | <b>99,210</b>     | <b>100,983</b>    | <b>99,121</b>    | <b>99,851</b>    |
| Anti-dilutive securities not included in treasury stock method computation         | 89                | 1,990             | 109              | 642              |

**Table of Contents****HCC Insurance Holdings, Inc. and Subsidiaries****Notes to Consolidated Financial Statements****(unaudited, tables in thousands except per share data)****(10) Stock-Based Compensation**

In 2013, we granted the following shares of common stock, shares of restricted stock, restricted stock units and stock options for the purchase of shares of our common stock.

|                        | Number<br>of shares | Weighted-average<br>grant date<br>fair value | Aggregate<br>fair value | Vesting<br>period |
|------------------------|---------------------|--|-------------------------|-------------------|
| Common stock           | 20                  | \$ 42.38                                     | \$ 840                  | None              |
| Restricted stock       | 160                 | 40.83  | 6,544                   | 1-4 years         |
| Restricted stock units | 16                  | 40.66  | 661                     | 4 years           |
| Stock options          | 109                 | 7.83   | 849                     | 1-5 years         |

For grants of common stock, we measure fair value based on the closing stock price of our common stock on the grant date and expense it on the grant date.

Certain awards of restricted stock and restricted stock units granted in 2013 contain a performance condition based on the ultimate results for the 2012 underwriting year. The number of such shares that vest could differ from the number initially granted. We measure fair value for these awards based on the closing price of our common stock on the grant date, and we recognize expense on a straight-line basis over the vesting period for those awards expected to vest. These awards earn dividends or dividend equivalents during the vesting period.

In 2013, we granted a new form of restricted stock to certain of our executive officers. This restricted stock vests after three years and can vest from 0% to 200% of the initial shares granted. Vesting is determined equally on an operating return on equity performance factor (ROE factor) and a total shareholder return performance factor (TSR factor) calculation. The ROE factor is calculated by comparing our actual results over the three-year period to an internal target, whereas the TSR factor is calculated by comparing our TSR over the three-year period to that of nine peer companies. The ROE factor qualifies as a performance condition and those awards are accounted for in the same manner as the other restricted stock grants described above. The TSR factor qualifies as a market condition and we determine the fair value at grant date using a Monte Carlo simulation model that takes into account the probabilities of numerous outcomes of our TSR as well as that of the peer companies. This fair value is expensed on a straight-line basis over the vesting period and is not adjusted for the ultimate number of shares to vest. No dividends are earned during the vesting period on these shares.

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 is expensed over the vesting period.

**(11) Segments**

We report HCC's results in six operating segments, including the following five insurance underwriting segments:

U.S. Property &amp; Casualty

U.S. Surety &amp; Credit

Professional Liability

International

Accident & Health

The Investing segment includes our consolidated 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.

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

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, foreign currency expense/benefit, and underwriting results of our Exited Lines.

Our Exited Lines include product lines that we no longer write and do not expect to write in the future. In the third quarter of 2012, we exited the HMO and medical excess reinsurance businesses that had previously been included in our Accident & Health segment. We have adjusted all prior financial data to report these two product lines in Exited Lines for the 2012 periods presented herein.

The following tables present information by business segment.

|                                       | U.S. Property<br>& Casualty | Professional<br>Liability | Accident<br>& Health | U.S. Surety<br>& Credit | International    | Investing         | Corporate<br>& Other | Consolidated      |
|---------------------------------------|-----------------------------|---------------------------|----------------------|-------------------------|------------------|-------------------|----------------------|-------------------|
| <b>Six months ended June 30, 2013</b> |                             |                           |                      |                         |                  |                   |                      |                   |
| Net earned premium                    | \$ 184,963                  | \$ 185,223                | \$ 434,947           | \$ 97,231               | \$ 210,412       | \$ -              | \$ 9,766             | \$ 1,122,542      |
| Other revenue                         | 11,429                      | 325                       | 2,330                | 621                     | 1,902            | 124,626           | 22                   | 141,255           |
| Segment revenue                       | 196,392                     | 185,548                   | 437,277              | 97,852                  | 212,314          | 124,626           | 9,788                | 1,263,797         |
| Loss and LAE                          | 107,394                     | 111,821                   | 320,566              | 18,851                  | 104,916          | -                 | 8,623                | 672,171           |
| Other expense                         | 52,757                      | 35,872                    | 63,709               | 53,681                  | 71,921           | -                 | 37,459               | 315,399           |
| Segment expense                       | 160,151                     | 147,693                   | 384,275              | 72,532                  | 176,837          | -                 | 46,082               | 987,570           |
| <b>Segment pretax earnings (loss)</b> | <b>\$ 36,241</b>            | <b>\$ 37,855</b>          | <b>\$ 53,002</b>     | <b>\$ 25,320</b>        | <b>\$ 35,477</b> | <b>\$ 124,626</b> | <b>\$ (36,294)</b>   | <b>\$ 276,227</b> |

**Six months ended June 30, 2012**

|                                       |                  |                  |                  |                  |                  |                   |                    |                   |
|---------------------------------------|------------------|------------------|------------------|------------------|------------------|-------------------|--------------------|-------------------|
| Net earned premium                    | \$ 177,852       | \$ 200,905       | \$ 415,028       | \$ 100,844       | \$ 196,472       | \$ -              | \$ 21,371          | \$ 1,112,472      |
| Other revenue                         | 6,885            | 267              | 2,494            | 415              | 2,135            | 116,950           | 193                | 129,339           |
| Segment revenue                       | 184,737          | 201,172          | 417,522          | 101,259          | 198,607          | 116,950           | 21,564             | 1,241,811         |
| Loss and LAE                          | 100,927          | 134,323          | 306,918          | 26,723           | 79,623           | -                 | 17,239             | 665,753           |
| Other expense                         | 59,767           | 36,207           | 61,102           | 55,523           | 68,765           | -                 | 43,415             | 324,779           |
| Segment expense                       | 160,694          | 170,530          | 368,020          | 82,246           | 148,388          | -                 | 60,654             | 990,532           |
| <b>Segment pretax earnings (loss)</b> | <b>\$ 24,043</b> | <b>\$ 30,642</b> | <b>\$ 49,502</b> | <b>\$ 19,013</b> | <b>\$ 50,219</b> | <b>\$ 116,950</b> | <b>\$ (39,090)</b> | <b>\$ 251,279</b> |



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

|   | U.S. Property<br>& Casualty | Professional<br>Liability | Accident<br>& Health | U.S. Surety<br>& Credit | International    | Investing        | Corporate<br>& Other | Consolidated      |
|---|-----------------------------|---------------------------|----------------------|-------------------------|------------------|------------------|----------------------|-------------------|
| <b>Three months ended June 30, 2013</b> |                             |                           |                      |                         |                  |                  |                      |                   |
| Net earned premium                      | \$ 91,432                   | \$ 92,444                 | \$ 217,822           | \$ 50,054               | \$ 105,270       | \$ -             | \$ 4,334             | \$ 561,356        |
| Other revenue                           | 4,245                       | 739                       | 1,140                | 384                     | 1,124            | 60,291           | 152                  | 68,075            |
| Segment revenue                         | 95,677                      | 93,183                    | 218,962              | 50,438                  | 106,394          | 60,291           | 4,486                | 629,431           |
| Loss and LAE                            | 55,238                      | 55,435                    | 160,139              | 5,637                   | 58,997           | -                | 4,028                | 339,474           |
| Other expense                           | 25,452                      | 18,124                    | 32,583               | 27,402                  | 36,212           | -                | 25,353               | 165,126           |
| Segment expense                         | 80,690                      | 73,559                    | 192,722              | 33,039                  | 95,209           | -                | 29,381               | 504,600           |
| <b>Segment pretax earnings (loss)</b>   | <b>\$ 14,987</b>            | <b>\$ 19,624</b>          | <b>\$ 26,240</b>     | <b>\$ 17,399</b>        | <b>\$ 11,185</b> | <b>\$ 60,291</b> | <b>\$ (24,895)</b>   | <b>\$ 124,831</b> |
| <b>Three months ended June 30, 2012</b> |                             |                           |                      |                         |                  |                  |                      |                   |
| Net earned premium                      | \$ 88,834                   | \$ 99,467                 | \$ 208,147           | \$ 53,115               | \$ 105,188       | \$ -             | \$ 10,580            | \$ 565,331        |
| Other revenue                           | 4,522                       | 134                       | 1,157                | 200                     | 941              | 59,769           | 234                  | 66,957            |
| Segment revenue                         | 93,356                      | 99,601                    | 209,304              | 53,315                  | 106,129          | 59,769           | 10,814               | 632,288           |
| Loss and LAE                            | 51,666                      | 65,168                    | 154,396              | 15,690                  | 41,856           | -                | 8,049                | 336,825           |
| Other expense                           | 30,045                      | 18,676                    | 30,948               | 27,403                  | 36,612           | -                | 17,460               | 161,144           |
| Segment expense                         | 81,711                      | 83,844                    | 185,344              | 43,093                  | 78,468           | -                | 25,509               | 497,969           |
| <b>Segment pretax earnings (loss)</b>   | <b>\$ 11,645</b>            | <b>\$ 15,757</b>          | <b>\$ 23,960</b>     | <b>\$ 10,222</b>        | <b>\$ 27,661</b> | <b>\$ 59,769</b> | <b>\$ (14,695)</b>   | <b>\$ 134,319</b> |

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

We have exposure to catastrophic 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 catastrophic losses are unpredictable. We assess our exposures in areas most vulnerable to natural catastrophes and apply procedures to ascertain our probable maximum loss from a single event. We maintain reinsurance protection that we believe is sufficient to limit our exposure to a foreseeable event. In 2013, we recognized accident year net catastrophe losses, after reinsurance and reinstatement premium, of \$26.6 million, primarily due to European floods during the second quarter and various small catastrophes, compared to \$12.3 million in the first six months of 2012, primarily due to United States spring storms and various small catastrophes.

**Litigation**

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

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, individually or in the aggregate, have a material adverse effect on 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)****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. We currently have claims under one indemnification that covers development on losses that were incurred prior to our sale of a subsidiary. At June 30, 2013, we have an accrued liability of \$7.7 million to cover our obligations or anticipated payments under these indemnifications.

**(13) Supplemental Information**

Supplemental cash flow information was as follows:

|   | <b>Six months ended June 30,</b> |             | <b>Three months ended June 30,</b> |             |
|---|----------------------------------|-------------|------------------------------------|-------------|
|   | <b>2013</b>                      | <b>2012</b> | <b>2013</b>                        | <b>2012</b> |
| Income taxes paid   | \$ 99,941                        | \$ 39,448   | \$ 67,799                          | \$ 33,664   |
| Interest paid   | 13,322                           | 12,000      | 11,932                             | 10,929      |
| Proceeds from sales of available for sale fixed maturity securities | 171,801                          | 218,572     | 13,666                             | 153,469     |
| Proceeds from sales of equity securities                            | 44,308                           | 1,739       | 26,500                             | 1,739       |
| Dividends declared but not paid at end of period                    | 16,523                           | 15,618      |                                    |             |

## **Table of Contents**

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

The following Management's Discussion and Analysis should be read in conjunction with our Consolidated Financial Statements and the related Notes as of June 30, 2013 and December 31, 2012.

#### **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 \$45.16 on July 26, 2013, resulting in market capitalization of \$4.5 billion.

We underwrite and manage a variety of largely non-correlated specialty insurance products through five insurance underwriting segments and our Investing segment. Our insurance underwriting segments are U.S. Property & Casualty, Professional Liability, Accident & Health, U.S. Surety & Credit and International. We market our insurance products through a network of independent agents and brokers, through managing general agents owned by the company, and directly to consumers. In addition, we assume insurance written by other insurance companies.

Our organization is focused on generating consistent, industry-leading combined ratios. We concentrate our insurance writings in selected specialty lines of business in which we believe we can achieve meaningful underwriting profit. We rely on experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to limit or reduce risk. By focusing on underwriting profitability, we are able to accomplish our primary objectives of maximizing net earnings and growing book value per share.

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, 2013 are as follows:

We had consolidated shareholders' equity of \$3.5 billion, with a book value per share of \$35.00.

We generated year-to-date net earnings of \$194.0 million, or \$1.92 per diluted share. Our second quarter earnings were \$88.2 million, or \$0.87 per diluted share.

We produced total revenue of \$1.3 billion and \$629.4 million in the first six months and second quarter, respectively.

Our year-to-date net loss ratio was 59.9% and our combined ratio was 84.5%.

Our debt to capital ratio was 15.4%.

We purchased \$40.9 million of our common stock at an average cost of \$39.96 per share in the first six months of 2013. At June 30, 2013, we had \$208.9 million remaining under our current \$300.0 million share buyback authorization.

We declared dividends of \$0.33 per share and paid \$33.3 million of dividends in the first six months of 2013.

Comparisons in the following sections refer to the first six months of 2013 compared to the same period of 2012. Amounts in tables are in thousands, except for earnings per share, percentages, ratios and number of employees. We adjusted all prior segment data to reflect our exit from two lines of business previously included in our Accident & Health segment (see Note 11, Segments to the Consolidated Financial Statements).



**Table of Contents****Results of Operations**

Our results and key metrics for the first six months and second quarter of 2013 and 2012 were as follows:

|                                   | Six months ended June 30, |            | Three months ended June 30, |           |
|-----------------------------------|---------------------------|------------|-----------------------------|-----------|
|                                   | 2013                      | 2012       | 2013                        | 2012      |
| <b>Net earnings</b>               | \$ 194,012                | \$ 176,077 | \$ 88,162                   | \$ 93,493 |
| <b>Earnings per diluted share</b> | \$ 1.92                   | \$ 1.71    | \$ 0.87                     | \$ 0.92   |
| <b>Net loss ratio</b>             | 59.9 %                    | 59.8 %     | 60.5 %                      | 59.6 %    |
| <b>Expense ratio*</b>             | 24.6                      | 25.5       | 24.8                        | 25.6      |
| <b>Combined ratio*</b>            | 84.5 %                    | 85.3 %     | 85.3 %                      | 85.2 %    |

\* 2012 adjusted to reflect change in Exited Lines.

In the second quarter of 2013, we recognized \$15.0 million of pretax catastrophe losses related to European floods, including \$2.0 million of inward reinstatement premium. In the first quarter of 2012, we recognized \$4.0 million of pretax catastrophe losses from United States spring storms. The 2013 losses were in the property treaty line of business within our International segment, and the 2012 losses were primarily in the public risk line of business within our U.S. Property & Casualty segment. Various other catastrophes that were not individually significant events to us or the industry (which we refer to as small catastrophes) that impacted our property treaty line of business totaled \$11.6 million in the first six months of 2013 (\$6.4 million in second quarter) and \$8.3 million (\$4.7 million) in the comparable periods of 2012. The following table summarizes our catastrophe losses, as well as the impact on our net earnings and key metrics in 2013 and 2012:

|   | Six months ended June 30, |           | Three months ended June 30, |           |
|---|---------------------------|-----------|-----------------------------|-----------|
|   | 2013                      | 2012      | 2013                        | 2012      |
| <b>Gross losses</b>                         | \$ 29,407                 | \$ 14,795 | \$ 19,801                   | \$ 7,735  |
| <b>Net losses, after reinsurance</b>        | \$ 29,921                 | \$ 12,668 | \$ 22,935                   | \$ 5,835  |
| <b>Reinstatement premium, net</b>           | (3,291)                   | (411)     | (1,515)                     | (1,182)   |
| <b>Total net catastrophe losses</b>         | \$ 26,630                 | \$ 12,257 | \$ 21,420                   | \$ 4,653  |
| <b>Impact of net catastrophe losses on:</b> |                           |           |                             |           |
| <b>Net earnings per diluted share</b>       | \$ (0.17)                 | \$ (0.08) | \$ (0.14)                   | \$ (0.03) |
| <b>Net loss ratio (percentage points)</b>   | 2.5 %                     | 1.1 %     | 4.0 %                       | 0.9 %     |
| <b>Combined ratio (percentage points)</b>   | 2.4 %                     | 1.1 %     | 4.0 %                       | 0.9 %     |

**Revenue**

Total revenue increased \$22.0 million in the first six months of 2013, compared to 2012, primarily due to higher net earned premium and net realized investment gains. Total revenue decreased in the second quarter of 2013, compared to the second quarter of 2012, primarily due to lower net earned premium.



## Table of Contents

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

|                                    | Six months ended June 30, |                     | Three months ended June 30, |                   |
|------------------------------------|---------------------------|---------------------|-----------------------------|-------------------|
|                                    | 2013                      | 2012                | 2013                        | 2012              |
| U.S. Property & Casualty           | \$ 358,388                | \$ 318,613          | \$ 183,251                  | \$ 165,466        |
| Professional Liability             | 246,393                   | 245,750             | 142,374                     | 144,505           |
| Accident & Health                  | 430,470                   | 412,875             | 214,909                     | 207,548           |
| U.S. Surety & Credit               | 111,438                   | 110,702             | 59,189                      | 56,209            |
| International                      | 373,193                   | 364,911             | 205,386                     | 207,235           |
| Exited Lines                       | 9,766                     | 21,391              | 4,334                       | 10,590            |
| <b>Total gross written premium</b> | <b>\$ 1,529,648</b>       | <b>\$ 1,474,242</b> | <b>\$ 809,443</b>           | <b>\$ 791,553</b> |

|                                  |                     |                     |                   |                   |
|----------------------------------|---------------------|---------------------|-------------------|-------------------|
| U.S. Property & Casualty         | \$ 208,869          | \$ 197,894          | \$ 104,987        | \$ 105,566        |
| Professional Liability           | 163,761             | 171,137             | 96,135            | 100,224           |
| Accident & Health                | 429,868             | 412,371             | 214,600           | 207,273           |
| U.S. Surety & Credit             | 98,128              | 96,096              | 52,624            | 51,392            |
| International                    | 297,826             | 301,623             | 156,354           | 167,053           |
| Exited Lines                     | 9,766               | 21,371              | 4,334             | 10,580            |
| <b>Total net written premium</b> | <b>\$ 1,208,218</b> | <b>\$ 1,200,492</b> | <b>\$ 629,034</b> | <b>\$ 642,088</b> |

|                                 |                     |                     |                   |                   |
|---------------------------------|---------------------|---------------------|-------------------|-------------------|
| U.S. Property & Casualty        | \$ 184,963          | \$ 177,852          | \$ 91,432         | \$ 88,834         |
| Professional Liability          | 185,223             | 200,905             | 92,444            | 99,467            |
| Accident & Health               | 434,947             | 415,028             | 217,822           | 208,147           |
| U.S. Surety & Credit            | 97,231              | 100,844             | 50,054            | 53,115            |
| International                   | 210,412             | 196,472             | 105,270           | 105,188           |
| Exited Lines                    | 9,766               | 21,371              | 4,334             | 10,580            |
| <b>Total net earned premium</b> | <b>\$ 1,122,542</b> | <b>\$ 1,112,472</b> | <b>\$ 561,356</b> | <b>\$ 565,331</b> |

Growth in premium from our insurance underwriting segments occurred primarily in: 1) the U.S. Property & Casualty segment, from new business lines started in 2011 and increased disability, residual value, title reinsurance and structured insurance products; 2) the Accident & Health segment, from the growth of our medical stop-loss product and 3) the International segment, from increases in our energy and property treaty lines of business in the first quarter of 2013. This growth was partially offset by lower premium in Exited Lines related to two products exited in the third quarter of 2012. See the Segment Operations section below for further discussion of the relationship and changes in premium revenue within each insurance segment.

Net investment income, which is included in our Investing segment, increased 1% year-over-year due to growth in our investment portfolio, partially offset by the effect of reduced reinvestment yields. The cost basis of our fixed maturity and equity securities portfolio increased 8% from \$5.8 billion at June 30, 2012 to \$6.3 billion at June 30, 2013. The growth resulted primarily from cash flow from operations.

**Table of Contents****Loss and Loss Adjustment Expense**

The tables below detail our net loss and loss adjustment expense and our net loss ratios on a consolidated basis and for our segments.

|                          | Six months ended June 30, |            | Three months ended June 30, |           |
|--------------------------|---------------------------|------------|-----------------------------|-----------|
|                          | 2013                      | 2012       | 2013                        | 2012      |
| U.S. Property & Casualty | \$ 107,394                | \$ 100,927 | \$ 55,238                   | \$ 51,666 |
| Professional Liability   | 111,821                   | 134,323    | 55,435                      | 65,168    |
| Accident & Health        | 320,566                   | 306,918    | 160,139                     | 154,396   |
| U.S. Surety & Credit     | 18,851                    | 26,723     | 5,637                       | 15,690    |
| International            | 104,916                   | 79,623     | 58,997                      | 41,856    |
| Exited Lines             | 8,623                     | 17,239     | 4,028                       | 8,049     |

|   |                   |                   |                   |                   |
|---|-------------------|-------------------|-------------------|-------------------|
| <b>Net loss and loss adjustment expense</b> | <b>\$ 672,171</b> | <b>\$ 665,753</b> | <b>\$ 339,474</b> | <b>\$ 336,825</b> |
|---|-------------------|-------------------|-------------------|-------------------|

|                          |        |        |        |        |
|--------------------------|--------|--------|--------|--------|
| U.S. Property & Casualty | 58.1 % | 56.7 % | 60.4 % | 58.2 % |
| Professional Liability   | 60.4   | 66.9   | 60.0   | 65.5   |
| Accident & Health        | 73.7   | 74.0   | 73.5   | 74.2   |
| U.S. Surety & Credit     | 19.4   | 26.5   | 11.3   | 29.5   |
| International            | 49.9   | 40.5   | 56.0   | 39.8   |

|                                    |               |               |               |               |
|------------------------------------|---------------|---------------|---------------|---------------|
| <b>Consolidated net loss ratio</b> | <b>59.9 %</b> | <b>59.8 %</b> | <b>60.5 %</b> | <b>59.6 %</b> |
|------------------------------------|---------------|---------------|---------------|---------------|

|  |               |               |               |               |
|--|---------------|---------------|---------------|---------------|
| <b>Consolidated accident year net loss ratio</b> | <b>60.9 %</b> | <b>59.8 %</b> | <b>62.6 %</b> | <b>59.6 %</b> |
|--|---------------|---------------|---------------|---------------|

Loss and loss adjustment expense increased marginally in the first six months of 2013, compared to the same period in 2012, primarily due to 1) our Accident & Health segment, from growth of our medical stop-loss product writings and 2) our International segment, from higher catastrophe losses and growth of our energy and property treaty lines of business, partially offset by 3) favorable development in 2013, primarily in our U.S. Surety & Credit segment and 4) decreased loss expense in our Professional Liability segment related to lower net earned premium and lower losses in our diversified financial products (DFP) line of business. We recognized \$11.8 million of favorable prior year loss development in the first six months and second quarter of 2013 and none in the corresponding periods of 2012. See the Segment Operations section below for additional discussion of the changes in our net loss and loss adjustment expense and net loss ratios for each segment.

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 30, |              |
|--|---------------------------|--------------|-----------------------------|--------------|
|  | 2013                      | 2012         | 2013                        | 2012         |
| Net reserves for loss and loss adjustment expense payable at beginning of period | \$ 2,749,803              | \$ 2,683,483 | \$ 2,761,242                | \$ 2,699,717 |
| Net reserve additions from acquired businesses                                   | -                         | 14,705       | -                           | -            |
| Foreign currency adjustment  | (24,627)                  | (4,456)      | (2,898)                     | (21,579)     |
| Net loss and loss adjustment expense   | 672,171                   | 665,753      | 339,474                     | 336,825      |
| Net loss and loss adjustment expense payments                                    | (586,326)                 | (610,490)    | (286,797)                   | (265,968)    |

|   |                     |                     |                     |                     |
|---|---------------------|---------------------|---------------------|---------------------|
| <b>Net reserves for loss and loss adjustment expense payable at end of period</b> | <b>\$ 2,811,021</b> | <b>\$ 2,748,995</b> | <b>\$ 2,811,021</b> | <b>\$ 2,748,995</b> |
|---|---------------------|---------------------|---------------------|---------------------|

|                            |        |        |        |        |
|----------------------------|--------|--------|--------|--------|
| <b>Net paid loss ratio</b> | 52.2 % | 54.9 % | 51.1 % | 47.0 % |
|----------------------------|--------|--------|--------|--------|

## **Table of Contents**

The amount of claims paid fluctuates year-over-year due to the timing of claims settlement, the occurrence of catastrophic events and commutations, and the mix of our business. In the first quarter of 2012, we commuted certain loss reserves on a large contract included in our Exited Lines for \$27.5 million. The commutation had no material effect on net earnings but increased our net paid loss ratio by 2.5 percentage points in the first six months of 2012. Excluding the commutation, our year-to-date net paid loss ratio was relatively flat year-over-year.

### ***Policy Acquisition Costs***

The percentage of policy acquisition costs to net earned premium was 12.3% and 12.9% for the first six months of 2013 and 2012, respectively, and 12.6% and 13.2% for the second quarter of 2013 and 2012, respectively. The difference between years primarily relates to higher ceding commissions in 2013 and changes in the mix of business.

### ***Other Operating Expense***

Other operating expense decreased 2% year-over-year and increased 9% quarter-over-quarter. The changes in other operating expense were primarily due to fluctuations in foreign currency benefit/expense and higher employee compensation and benefit costs in 2013. We recognized a foreign currency benefit of \$9.0 million and an expense of \$1.9 million in the first six months and second quarter of 2013, respectively. Our foreign currency benefit was \$1.4 million and \$4.2 million in the first six months and second quarter of 2012, respectively. The foreign currency benefit in the first quarter of 2013 primarily related to changes in the value of the British pound sterling relative to the U.S. dollar, and the expense in the second quarter of 2013 primarily related to changes in the value of the Euro relative to the U.S. dollar.

Excluding the effect of foreign currency benefit/expense, other operating expense increased 3% year-over-year and 1% quarter-over-quarter, mainly due to increased compensation and benefit costs in 2013 for our 1,903 employees. Approximately 64% and 61% of our other operating expense (excluding foreign currency benefit/expense) in 2013 and 2012, respectively, related to compensation and benefits. Other operating expense included stock-based compensation expense of \$7.2 million in 2013 and \$6.4 million in 2012. At June 30, 2013, there was approximately \$25.8 million of total unrecognized compensation expense related to unvested options, shares of restricted stock and restricted stock units that is expected to be recognized over a weighted-average period of 2.8 years.

### ***Interest Expense***

Interest expense was \$13.1 million in the first six months of 2013 and 2012, and \$6.6 million and \$6.2 million in the second quarter of 2013 and 2012, respectively. The year-to-date interest expense for 2013 and 2012 included \$9.7 million for our Senior Notes.

### ***Income Tax Expense***

Our year-to-date effective income tax rate was flat at 29.8% for 2013, compared to 29.9% for 2012.

**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. Certain 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 occurrences. 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 insurance 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 30, |                   | Three months ended June 30, |                  |
|---------------------------------------|---------------------------|-------------------|-----------------------------|------------------|
|                                       | 2013                      | 2012              | 2013                        | 2012             |
| Net earned premium                    | \$ 184,963                | \$ 177,852        | \$ 91,432                   | \$ 88,834        |
| Other revenue                         | 11,429                    | 6,885             | 4,245                       | 4,522            |
| <b>Segment revenue</b>                | <b>196,392</b>            | <b>184,737</b>    | <b>95,677</b>               | <b>93,356</b>    |
| Loss and loss adjustment expense, net | 107,394                   | 100,927           | 55,238                      | 51,666           |
| Other expense                         | 52,757                    | 59,767            | 25,452                      | 30,045           |
| <b>Segment expense</b>                | <b>160,151</b>            | <b>160,694</b>    | <b>80,690</b>               | <b>81,711</b>    |
| <b>Segment pretax earnings</b>        | <b>\$ 36,241</b>          | <b>\$ 24,043</b>  | <b>\$ 14,987</b>            | <b>\$ 11,645</b> |
| <b>Net loss ratio</b>                 | <b>58.1 %</b>             | <b>56.7 %</b>     | <b>60.4 %</b>               | <b>58.2 %</b>    |
| <b>Expense ratio</b>                  | <b>26.9</b>               | <b>32.4</b>       | <b>26.6</b>                 | <b>32.2</b>      |
| <b>Combined ratio</b>                 | <b>85.0 %</b>             | <b>89.1 %</b>     | <b>87.0 %</b>               | <b>90.4 %</b>    |
| Aviation                              | \$ 56,286                 | \$ 58,220         | \$ 28,429                   | \$ 29,397        |
| E&O                                   | 26,433                    | 31,979            | 13,235                      | 15,602           |
| Public Risk                           | 32,755                    | 31,792            | 16,395                      | 16,574           |
| Other                                 | 69,489                    | 55,861            | 33,373                      | 27,261           |
| <b>Total net earned premium</b>       | <b>\$ 184,963</b>         | <b>\$ 177,852</b> | <b>\$ 91,432</b>            | <b>\$ 88,834</b> |
| Aviation                              | 63.0 %                    | 55.8 %            | 64.3 %                      | 64.5 %           |
| E&O                                   | 61.1                      | 60.8              | 61.9                        | 60.6             |
| Public Risk                           | 76.7                      | 77.8              | 75.1                        | 63.9             |
| Other                                 | 44.1                      | 43.4              | 49.3                        | 46.4             |

|                             |        |        |        |        |
|-----------------------------|--------|--------|--------|--------|
| <b>Total net loss ratio</b> | 58.1 % | 56.7 % | 60.4 % | 58.2 % |
|-----------------------------|--------|--------|--------|--------|

**Table of Contents**

|                                    | Six months ended June 30, |                   | Three months ended June 30, |                   |
|------------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
|                                    | 2013                      | 2012              | 2013                        | 2012              |
| Aviation                           | \$ 75,182                 | \$ 82,870         | \$ 38,184                   | \$ 45,780         |
| E&O                                | 28,328                    | 31,493            | 13,254                      | 14,602            |
| Public Risk                        | 37,105                    | 43,245            | 15,664                      | 23,461            |
| Other                              | 217,773                   | 161,005           | 116,149                     | 81,623            |
| <b>Total gross written premium</b> | <b>\$ 358,388</b>         | <b>\$ 318,613</b> | <b>\$ 183,251</b>           | <b>\$ 165,466</b> |
| Aviation                           | \$ 60,134                 | \$ 63,405         | \$ 31,520                   | \$ 35,898         |
| E&O                                | 24,691                    | 30,235            | 12,153                      | 13,730            |
| Public Risk                        | 29,880                    | 35,567            | 14,109                      | 19,973            |
| Other                              | 94,164                    | 68,687            | 47,205                      | 35,965            |
| <b>Total net written premium</b>   | <b>\$ 208,869</b>         | <b>\$ 197,894</b> | <b>\$ 104,987</b>           | <b>\$ 105,566</b> |

Our U.S. Property & Casualty segment pretax earnings increased 51% year-over-year primarily due to a combination of the following: 1) no catastrophe losses in 2013, compared to \$4.0 million in 2012, 2) higher ceding commissions in 2013 and 3) higher other revenue. Net earned premium increased in 2013, compared to 2012, due to higher writings by our new underwriting teams for the technical property, primary casualty and excess casualty lines of business, as well as for disability, residual value, title reinsurance, and structured insurance products (all grouped in Other).

Our aviation line of business experienced higher losses in the first quarter of 2013, compared to the same period in 2012. Our year-to-date public risk loss ratios were relatively consistent, as catastrophe losses in the first quarter of 2012 have been matched by higher non-catastrophe losses in 2013. Other expense and the expense ratio were lower in 2013 primarily due to higher ceding commissions (that offset policy acquisition costs) from increased writings of our highly-ceded disability product. In addition, a \$2.5 million recovery of an indemnification liability in the second quarter of 2013 reduced the segment's year-to-date and quarter-to-date expense ratio by 1.3 and 2.6 percentage points, respectively.

**Table of Contents****Professional Liability Segment**

The following tables summarize the operations of the Professional Liability segment.

|                                       | Six months ended June 30, |                   | Three months ended June 30, |                   |
|---------------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
|                                       | 2013                      | 2012              | 2013                        | 2012              |
| Net earned premium                    | \$ 185,223                | \$ 200,905        | \$ 92,444                   | \$ 99,467         |
| Other revenue                         | 325                       | 267               | 739                         | 134               |
| <b>Segment revenue</b>                | <b>185,548</b>            | <b>201,172</b>    | <b>93,183</b>               | <b>99,601</b>     |
| Loss and loss adjustment expense, net | 111,821                   | 134,323           | 55,435                      | 65,168            |
| Other expense                         | 35,872                    | 36,207            | 18,124                      | 18,676            |
| <b>Segment expense</b>                | <b>147,693</b>            | <b>170,530</b>    | <b>73,559</b>               | <b>83,844</b>     |
| <b>Segment pretax earnings</b>        | <b>\$ 37,855</b>          | <b>\$ 30,642</b>  | <b>\$ 19,624</b>            | <b>\$ 15,757</b>  |
| <b>Net loss ratio</b>                 | <b>60.4 %</b>             | <b>66.9 %</b>     | <b>60.0 %</b>               | <b>65.5 %</b>     |
| <b>Expense ratio</b>                  | <b>19.3</b>               | <b>18.0</b>       | <b>19.4</b>                 | <b>18.8</b>       |
| <b>Combined ratio</b>                 | <b>79.7 %</b>             | <b>84.9 %</b>     | <b>79.4 %</b>               | <b>84.3 %</b>     |
| U.S. D&O                              | \$ 153,721                | \$ 170,667        | \$ 77,016                   | \$ 84,413         |
| International D&O                     | 31,502                    | 30,238            | 15,428                      | 15,054            |
| <b>Total net earned premium</b>       | <b>\$ 185,223</b>         | <b>\$ 200,905</b> | <b>\$ 92,444</b>            | <b>\$ 99,467</b>  |
| U.S. D&O                              | 62.8 %                    | 69.7 %            | 62.8 %                      | 68.3 %            |
| International D&O                     | 48.6                      | 51.0              | 45.9                        | 50.1              |
| <b>Total net loss ratio</b>           | <b>60.4 %</b>             | <b>66.9 %</b>     | <b>60.0 %</b>               | <b>65.5 %</b>     |
| U.S. D&O                              | \$ 186,845                | \$ 186,184        | \$ 111,606                  | \$ 111,188        |
| International D&O                     | 59,548                    | 59,566            | 30,768                      | 33,317            |
| <b>Total gross written premium</b>    | <b>\$ 246,393</b>         | <b>\$ 245,750</b> | <b>\$ 142,374</b>           | <b>\$ 144,505</b> |
| U.S. D&O                              | \$ 129,578                | \$ 136,826        | \$ 77,879                   | \$ 81,121         |
| International D&O                     | 34,183                    | 34,311            | 18,256                      | 19,103            |

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

|                                  |    |         |    |         |    |        |    |         |
|----------------------------------|----|---------|----|---------|----|--------|----|---------|
| <b>Total net written premium</b> | \$ | 163,761 | \$ | 171,137 | \$ | 96,135 | \$ | 100,224 |
|----------------------------------|----|---------|----|---------|----|--------|----|---------|

Our Professional Liability segment pretax earnings increased 24% year-to-date in 2013, compared to 2012, due to an improved net loss ratio, primarily related to reunderwriting of our diversified financial products (DFP) line of business in U.S. D&O beginning in 2012.

Gross written premium was essentially unchanged year-over-year. However, within U.S. D&O, increased writings of our directors and officers liability product offset a decrease in DFP. Net written premium decreased 4% year-over-year primarily due to reduced retention under our reinsurance program. Net earned premium decreased in 2013 primarily due to our reunderwriting of the DFP book of business in 2012 and the additional reinsurance.

**Table of Contents*****Accident & Health Segment***

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

|                                       | <b>Six months ended June 30,</b> |                   | <b>Three months ended June 30,</b> |                   |
|---------------------------------------|----------------------------------|-------------------|------------------------------------|-------------------|
|                                       | <b>2013</b>                      | <b>2012</b>       | <b>2013</b>                        | <b>2012</b>       |
| Net earned premium                    | \$ 434,947                       | \$ 415,028        | \$ 217,822                         | \$ 208,147        |
| Other revenue                         | 2,330                            | 2,494             | 1,140                              | 1,157             |
| <b>Segment revenue</b>                | <b>437,277</b>                   | <b>417,522</b>    | <b>218,962</b>                     | <b>209,304</b>    |
| Loss and loss adjustment expense, net | 320,566                          | 306,918           | 160,139                            | 154,396           |
| Other expense                         | 63,709                           | 61,102            | 32,583                             | 30,948            |
| <b>Segment expense</b>                | <b>384,275</b>                   | <b>368,020</b>    | <b>192,722</b>                     | <b>185,344</b>    |
| <b>Segment pretax earnings</b>        | <b>\$ 53,002</b>                 | <b>\$ 49,502</b>  | <b>\$ 26,240</b>                   | <b>\$ 23,960</b>  |
| <b>Net loss ratio</b>                 | <b>73.7 %</b>                    | <b>74.0 %</b>     | <b>73.5 %</b>                      | <b>74.2 %</b>     |
| <b>Expense ratio</b>                  | <b>14.6</b>                      | <b>14.6</b>       | <b>14.9</b>                        | <b>14.8</b>       |
| <b>Combined ratio</b>                 | <b>88.3 %</b>                    | <b>88.6 %</b>     | <b>88.4 %</b>                      | <b>89.0 %</b>     |
| Medical Stop-loss                     | \$ 404,604                       | \$ 387,673        | \$ 202,010                         | \$ 194,586        |
| Other                                 | 30,343                           | 27,355            | 15,812                             | 13,561            |
| <b>Total net earned premium</b>       | <b>\$ 434,947</b>                | <b>\$ 415,028</b> | <b>\$ 217,822</b>                  | <b>\$ 208,147</b> |
| Medical Stop-loss                     | 75.2 %                           | 75.5 %            | 75.2 %                             | 75.7 %            |
| Other                                 | 53.9                             | 52.3              | 51.8                               | 52.9              |
| <b>Total net loss ratio</b>           | <b>73.7 %</b>                    | <b>74.0 %</b>     | <b>73.5 %</b>                      | <b>74.2 %</b>     |
| Medical Stop-loss                     | \$ 405,039                       | \$ 387,974        | \$ 202,231                         | \$ 194,741        |
| Other                                 | 25,431                           | 24,901            | 12,678                             | 12,807            |
| <b>Total gross written premium</b>    | <b>\$ 430,470</b>                | <b>\$ 412,875</b> | <b>\$ 214,909</b>                  | <b>\$ 207,548</b> |
| Medical Stop-loss                     | \$ 404,604                       | \$ 387,673        | \$ 202,010                         | \$ 194,586        |
| Other                                 | 25,264                           | 24,698            | 12,590                             | 12,687            |

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

|                                  |    |         |    |         |    |         |    |         |
|----------------------------------|----|---------|----|---------|----|---------|----|---------|
| <b>Total net written premium</b> | \$ | 429,868 | \$ | 412,371 | \$ | 214,600 | \$ | 207,273 |
|----------------------------------|----|---------|----|---------|----|---------|----|---------|

The Accident & Health segment pretax earnings increased 7% in the first six months of 2013, compared to the same period of 2012. This increase was directly related to higher net earned premium in our medical stop-loss product line due to writing new business and rate increases on renewal business.

The 2012 information shown above has been adjusted to reflect our exit from two lines of business in the third quarter of 2012. See Note 11, Segments to the Consolidated Financial Statements.

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

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

|                                       | <b>Six months ended June 30</b> |                   | <b>Three months ended June 30,</b> |                  |
|---------------------------------------|---------------------------------|-------------------|------------------------------------|------------------|
|                                       | <b>2013</b>                     | <b>2012</b>       | <b>2013</b>                        | <b>2012</b>      |
| Net earned premium                    | \$ 97,231                       | \$ 100,844        | \$ 50,054                          | \$ 53,115        |
| Other revenue                         | 621                             | 415               | 384                                | 200              |
| <b>Segment revenue</b>                | <b>97,852</b>                   | <b>101,259</b>    | <b>50,438</b>                      | <b>53,315</b>    |
| Loss and loss adjustment expense, net | 18,851                          | 26,723            | 5,637                              | 15,690           |
| Other expense                         | 53,681                          | 55,523            | 27,402                             | 27,403           |
| <b>Segment expense</b>                | <b>72,532</b>                   | <b>82,246</b>     | <b>33,039</b>                      | <b>43,093</b>    |
| <b>Segment pretax earnings</b>        | <b>\$ 25,320</b>                | <b>\$ 19,013</b>  | <b>\$ 17,399</b>                   | <b>\$ 10,222</b> |
| <b>Net loss ratio</b>                 | <b>19.4 %</b>                   | <b>26.5 %</b>     | <b>11.3 %</b>                      | <b>29.5 %</b>    |
| <b>Expense ratio</b>                  | <b>54.9</b>                     | <b>54.8</b>       | <b>54.3</b>                        | <b>51.4</b>      |
| <b>Combined ratio</b>                 | <b>74.3 %</b>                   | <b>81.3 %</b>     | <b>65.6 %</b>                      | <b>80.9 %</b>    |
| Surety                                | \$ 72,725                       | \$ 79,608         | \$ 37,118                          | \$ 39,688        |
| Credit                                | 24,506                          | 21,236            | 12,936                             | 13,427           |
| <b>Total net earned premium</b>       | <b>\$ 97,231</b>                | <b>\$ 100,844</b> | <b>\$ 50,054</b>                   | <b>\$ 53,115</b> |
| Surety                                | 19.8 %                          | 24.8 %            | 14.9 %                             | 24.8 %           |
| Credit                                | 18.1                            | 33.0              | 0.8                                | 43.7             |
| <b>Total net loss ratio</b>           | <b>19.4 %</b>                   | <b>26.5 %</b>     | <b>11.3 %</b>                      | <b>29.5 %</b>    |
| Surety                                | \$ 80,327                       | \$ 80,762         | \$ 42,631                          | \$ 40,836        |
| Credit                                | 31,111                          | 29,940            | 16,558                             | 15,373           |
| <b>Total gross written premium</b>    | <b>\$ 111,438</b>               | <b>\$ 110,702</b> | <b>\$ 59,189</b>                   | <b>\$ 56,209</b> |
| Surety                                | \$ 72,146                       | \$ 73,385         | \$ 38,456                          | \$ 37,251        |
| Credit                                | 25,982                          | 22,711            | 14,168                             | 14,141           |

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

|                                  |    |        |    |        |    |        |    |        |
|----------------------------------|----|--------|----|--------|----|--------|----|--------|
| <b>Total net written premium</b> | \$ | 98,128 | \$ | 96,096 | \$ | 52,624 | \$ | 51,392 |
|----------------------------------|----|--------|----|--------|----|--------|----|--------|

Our U.S. Surety & Credit segment pretax earnings increased 33% year-over-year and 70% quarter-over-quarter, primarily due to favorable loss development in the second quarter of 2013. Net earned premium for our surety line of business decreased year-over-year, primarily due to competition and market conditions.

The segment had favorable loss development of \$9.5 million in 2013 and none in 2012. We conduct our annual comprehensive review of this segment's reserves in the fourth quarter, which we will do for 2013. However, in the first half of 2013, we settled a large 2010 claim on favorable terms, which generated \$5.8 million of reserve redundancy, and we noted continued lower than expected claims activity related to older underwriting years. As a result, we conducted a limited review of the segment's reserves during the second quarter. This review indicated that actual loss experience for the 2010 and prior underwriting years was significantly better in 2013 than the actuarial expectations in our 2012 comprehensive review. In view of the growing redundancy in the segment's reserves, we recognized favorable development of \$3.7 million for surety and \$5.8 million for credit related to the 2010 and prior underwriting years in the second quarter of 2013.

**Table of Contents****International Segment**

The following tables summarize the operations of the International segment.

|                                       | Six months ended June 30, |                   | Three months ended June 30, |                   |
|---------------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
|                                       | 2013                      | 2012              | 2013                        | 2012              |
| Net earned premium                    | \$ 210,412                | \$ 196,472        | \$ 105,270                  | \$ 105,188        |
| Other revenue                         | 1,902                     | 2,135             | 1,124                       | 941               |
| <b>Segment revenue</b>                | <b>212,314</b>            | <b>198,607</b>    | <b>106,394</b>              | <b>106,129</b>    |
| Loss and loss adjustment expense, net | 104,916                   | 79,623            | 58,997                      | 41,856            |
| Other expense                         | 71,921                    | 68,765            | 36,212                      | 36,612            |
| <b>Segment expense</b>                | <b>176,837</b>            | <b>148,388</b>    | <b>95,209</b>               | <b>78,468</b>     |
| <b>Segment pretax income</b>          | <b>\$ 35,477</b>          | <b>\$ 50,219</b>  | <b>\$ 11,185</b>            | <b>\$ 27,661</b>  |
| <b>Net loss ratio</b>                 | <b>49.9 %</b>             | <b>40.5 %</b>     | <b>56.0 %</b>               | <b>39.8 %</b>     |
| <b>Expense ratio</b>                  | <b>33.9</b>               | <b>34.6</b>       | <b>34.0</b>                 | <b>34.5</b>       |
| <b>Combined ratio</b>                 | <b>83.8 %</b>             | <b>75.1 %</b>     | <b>90.0 %</b>               | <b>74.3 %</b>     |
| Energy                                | \$ 43,457                 | \$ 40,889         | \$ 22,418                   | \$ 25,795         |
| Property Treaty                       | 58,498                    | 49,007            | 29,743                      | 26,918            |
| Liability                             | 35,583                    | 39,131            | 18,408                      | 19,649            |
| Surety & Credit                       | 36,066                    | 34,945            | 17,853                      | 17,184            |
| Other                                 | 36,808                    | 32,500            | 16,848                      | 15,642            |
| <b>Total net earned premium</b>       | <b>\$ 210,412</b>         | <b>\$ 196,472</b> | <b>\$ 105,270</b>           | <b>\$ 105,188</b> |
| Energy                                | 45.4 %                    | 41.6 %            | 45.5 %                      | 44.2 %            |
| Property Treaty                       | 51.1                      | 17.7              | 77.1                        | 21.7              |
| Liability                             | 49.4                      | 49.5              | 48.9                        | 47.9              |
| Surety & Credit                       | 63.0                      | 58.2              | 62.5                        | 48.2              |
| Other                                 | 40.6                      | 43.7              | 33.9                        | 44.2              |
| <b>Total net loss ratios</b>          | <b>49.9 %</b>             | <b>40.5 %</b>     | <b>56.0 %</b>               | <b>39.8 %</b>     |
| Energy                                | \$ 111,859                | \$ 110,714        | \$ 85,314                   | \$ 90,119         |
| Property Treaty                       | 113,995                   | 113,855           | 41,650                      | 44,517            |
| Liability                             | 40,210                    | 40,242            | 22,077                      | 20,982            |
| Surety & Credit                       | 46,196                    | 43,451            | 25,030                      | 22,493            |

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

|                                    |            |            |            |            |
|------------------------------------|------------|------------|------------|------------|
| Other                              | 60,933     | 56,649     | 31,315     | 29,124     |
| <b>Total gross written premium</b> | \$ 373,193 | \$ 364,911 | \$ 205,386 | \$ 207,235 |

35

**Table of Contents**

|                                  | Six months ended June 30, |                   | Three months ended June 30, |                   |
|----------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
|                                  | 2013                      | 2012              | 2013                        | 2012              |
| Energy                           | \$ 71,120                 | \$ 81,013         | \$ 56,451                   | \$ 68,189         |
| Property Treaty                  | 101,266                   | 99,819            | 35,099                      | 37,517            |
| Liability                        | 37,577                    | 37,316            | 21,007                      | 19,424            |
| Surety & Credit                  | 40,290                    | 39,813            | 21,641                      | 20,786            |
| Other                            | 47,573                    | 43,662            | 22,156                      | 21,137            |
| <b>Total net written premium</b> | <b>\$ 297,826</b>         | <b>\$ 301,623</b> | <b>\$ 156,354</b>           | <b>\$ 167,053</b> |

Our International segment pretax earnings decreased \$14.7 million in the first six months and \$16.5 million in the second quarter of 2013, compared to the same periods of 2012, primarily due to the impact of higher net catastrophe losses in our property treaty line of business in 2013. In the second quarter of 2013, we recognized \$15.0 million of pretax catastrophe losses related to European floods, including \$2.0 million of inward reinstatement premium. The remaining net losses in 2013 and 2012 related to small catastrophes. The following table summarizes the segment's net catastrophe losses, as well as the impact on key metrics:

|   | Six months ended June 30, |                 | Three months ended June 30, |                 |
|---|---------------------------|-----------------|-----------------------------|-----------------|
|   | 2013                      | 2012            | 2013                        | 2012            |
| Loss and loss adjustment expense, after reinsurance   | \$ 29,921                 | \$ 8,668        | \$ 22,935                   | \$ 5,835        |
| Reinstatement premium, net                            | (3,291)                   | (411)           | (1,515)                     | (1,182)         |
| <b>Total net catastrophe losses</b>                   | <b>\$ 26,630</b>          | <b>\$ 8,257</b> | <b>\$ 21,420</b>            | <b>\$ 4,653</b> |
| Impact of net catastrophe losses (percentage points): |                           |                 |                             |                 |
| Net loss ratio  | 13.7 %                    | 4.3 %           | 21.2 %                      | 5.2 %           |
| Expense ratio   | (0.5)                     | (0.1)           | (0.5)                       | (0.4)           |
| <b>Combined ratio</b>                                 | <b>13.2 %</b>             | <b>4.2 %</b>    | <b>20.7 %</b>               | <b>4.8 %</b>    |

In the second quarter of 2013, we recognized favorable loss development of \$2.3 million in the property line of business (included in Other) related to our 2010 New Zealand earthquake catastrophe losses, due to settlement of these claims in 2013.

The segment's increase in net earned premium in 2013 primarily related to increased writings of our energy and property treaty lines of business during 2012. The decrease in net written premium primarily related to additional reinsurance on our energy line of business in 2013.

A recent ruling against another insurance company by the Spanish supreme court regarding a specific class of Spanish surety bonds, which are similar to those written by our Spanish subsidiary, may result in an increase in the segment's recorded loss reserves for surety claims in the Surety & Credit line of business. At the present time, it is not possible for us to determine the impact, if any, on our recorded reserves until we complete our analysis of the applicability of this ruling to our bonds. The court's ruling is expected to be published in the third quarter of 2013.

**Table of Contents****Investing Segment**

We invest the majority of our funds in highly-rated fixed maturity securities, which are designated as available for sale securities. We held \$6.1 billion of fixed maturity securities at June 30, 2013. Substantially all of our fixed maturity securities were investment grade and 73% were rated AAA or AA.

The following tables summarize the results and key metrics of our Investing segment.

|   | Six months ended June 30, |                   | Three months ended June 30, |                  |
|---|---------------------------|-------------------|-----------------------------|------------------|
|   | 2013                      | 2012              | 2013                        | 2012             |
| Fixed maturity securities                     | \$ 107,097                | \$ 111,090        | \$ 53,248                   | \$ 53,363        |
| Equity securities                             | 7,808                     | 993               | 4,228                       | 993              |
| Short-term investments                        | 80                        | 102               | 68                          | 40               |
| Other investments and deposits                | 319                       | 868               | 366                         | 401              |
| Net realized investment gain                  | 13,193                    | 7,047             | 4,623                       | 6,876            |
| Other-than-temporary impairment credit losses | -                         | (397)             | -                           | (397)            |
| Investment expenses                           | (3,871)                   | (2,753)           | (2,242)                     | (1,507)          |
| <b>Segment pretax earnings</b>                | <b>\$ 124,626</b>         | <b>\$ 116,950</b> | <b>\$ 60,291</b>            | <b>\$ 59,769</b> |

|                               |           |           |       |       |
|-------------------------------|-----------|-----------|-------|-------|
| Fixed maturity securities:    |           |           |       |       |
| Average yield*                | 3.7 %     | 3.9 %     | 3.6 % | 3.8 % |
| Average tax equivalent yield* | 4.5 %     | 4.8 %     | 4.5 % | 4.6 % |
| Weighted-average life         | 8.4 years | 7.8 years |       |       |
| Weighted-average duration     | 5.5 years | 4.5 years |       |       |
| Weighted-average rating       | AA        | AA        |       |       |

\* Excluding realized and unrealized gains and losses.

In the past several years, the average yield on our fixed maturity securities has continued to decline due to persistently lower interest rates on new investments. We have addressed this issue by investing longer-term, especially in tax-exempt municipal bonds, in anticipation of a prolonged low interest rate environment and, since 2012, by investing in new classes of securities with attractive yields and low/no duration. These new classes of investments include bank loans, which are classified as corporate securities, and global publicly-traded equity securities. At June 30, 2013, our investments included \$151.9 million of bank loans and \$347.8 million of equity securities, compared to \$91.5 million and \$93.7 million, respectively, at June 30, 2012.

In the second quarter of 2013, our duration increased significantly from 4.9 years at March 31, 2013 to 5.5 years at June 30, 2013. The higher duration was directly related to increased prevailing interest rates and spreads since March 31, 2013, due to investor concerns that the U.S. Federal government would tighten its fiscal policies. In the second quarter, rates on 10-year U.S. Treasury notes rose 74 basis points to their highest level in two years.

These rising interest rates considerably impacted the fair value of our fixed maturity securities portfolio at June 30, 2013, as described below. Conversely, the higher interest rates will result in more attractive yields as we invest our future cash flows.

**Table of Contents**

This table summarizes our investments by type, all of which were reported at fair value, at June 30, 2013 and December 31, 2012. The methodologies used to determine the fair value of our investments are described in Note 4, Fair Value Measurements to the Consolidated Financial Statements.

|  | June 30, 2013       |              | December 31, 2012   |              |
|--|---------------------|--------------|---------------------|--------------|
|  | Amount              | %            | Amount              | %            |
| Fixed maturity securities  |                     |              |                     |              |
| U.S. government and government agency securities                                   | \$ 123,664          | 2 %          | \$ 199,607          | 3 %          |
| Fixed maturity securities of states, municipalities and political subdivisions     | 1,029,817           | 15           | 1,065,811           | 15           |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 2,271,620           | 34           | 2,200,331           | 32           |
| Corporate securities   | 1,236,645           | 19           | 1,315,170           | 19           |
| Residential mortgage-backed securities   | 605,495             | 9            | 664,887             | 10           |
| Commercial mortgage-backed securities  | 536,199             | 8            | 524,289             | 8            |
| Asset-backed securities  | 54,291              | 1            | 33,275              | -            |
| Foreign government securities  | 236,909             | 4            | 278,411             | 4            |
| Equity securities  | 347,840             | 5            | 284,639             | 4            |
| Short-term investments   | 216,793             | 3            | 363,053             | 5            |
| Other investments  | 18                  | -            | 20,925              | -            |
| <b>Total investments</b>   | <b>\$ 6,659,291</b> | <b>100 %</b> | <b>\$ 6,950,398</b> | <b>100 %</b> |

Our total investments decreased \$291.1 million in 2013, principally from: 1) a \$260.6 million decrease in the pretax net unrealized gain and 2) return of \$74.3 million of collateral held for our surety business in the first six months of 2013. At June 30, 2013, the net unrealized gain on our investment portfolio was \$176.1 million, compared to \$397.7 million at March 31, 2013 and \$436.7 million at December 31, 2012. The significant decline in the net unrealized gain was due to the rise in interest rates in the second quarter of 2013, discussed previously.

The ratings of our individual securities within our fixed maturity securities portfolio at June 30, 2013 were as follows:

|  | Amount              | %            |
|--|---------------------|--------------|
| AAA                                    | \$ 829,116          | 14 %         |
| AA                                     | 3,593,526           | 59           |
| A                                      | 1,243,387           | 20           |
| BBB                                    | 272,653             | 4            |
| BB and below                           | 155,958             | 3            |
| <b>Total fixed maturity securities</b> | <b>\$ 6,094,640</b> | <b>100 %</b> |

At June 30, 2013, we held \$2.3 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 as municipal bonds in the investment market. The overall rating of our municipal bonds was AA at June 30, 2013. Within our municipal bond portfolio, we held \$429.7 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, 2013, the percentages of our special purpose revenue bond portfolio supported by these major revenue sources were as follows: 1) education 23%, 2) transportation 23%, 3) water and sewer 17% and 4) electric 15%.

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

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

special purpose revenue bond and periodically thereafter. The underlying average credit rating of our special purpose revenue bond issuers, excluding any bond insurance, was AA at June 30, 2013. Although recent economic

**Table of Contents**

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, 2013, we held corporate fixed maturity securities issued by foreign corporations with an aggregate fair value of \$507.1 million. In addition, we held securities issued by foreign governments, agencies or supranational entities with an aggregate fair value of \$236.9 million.

Some of our fixed maturity securities have call or prepayment options. In addition, mortgage-backed and certain asset-backed securities have prepayment, extension or other market-related credit risk. Calls and prepayments subject us to reinvestment risk should interest rates fall and issuers call their securities and we reinvest the proceeds at lower interest rates. Prepayment risk exists if cash flows from the repayment of principal occur earlier than anticipated because of declining interest rates. Extension risk exists if cash flows from the repayment of principal occur later than anticipated because of rising interest rates. Credit risk exists if mortgagees default on the underlying mortgages. Net investment income and/or cash flows from investments that have call or prepayment options and prepayment, extension or credit risk may differ from what was anticipated at the time of investment. We mitigate these risks by investing in investment grade securities with varied maturity dates so that only a portion of our portfolio will mature at any point in time. Through December 31, 2014, we expect approximately 11% of our fixed maturity securities portfolio to mature, call or prepay. Assuming prevailing interest rates remain constant for the next eighteen months, reinvestment of these funds will be at book yields and tax-equivalent yields that are approximately 100 basis points lower than the current yields for these securities.

**Corporate & Other**

The following table summarizes activity in the Corporate & Other category.

|                                       | Six months ended June 30, |                    | Three months ended June 30, |                    |
|---------------------------------------|---------------------------|--------------------|-----------------------------|--------------------|
|                                       | 2013                      | 2012               | 2013                        | 2012               |
| Net earned premium                    | \$ 9,766                  | \$ 21,371          | \$ 4,334                    | \$ 10,580          |
| Other revenue                         | 22                        | 193                | 152                         | 234                |
| <b>Total revenue</b>                  | <b>9,788</b>              | <b>21,564</b>      | <b>4,486</b>                | <b>10,814</b>      |
| Loss and loss adjustment expense, net | 8,623                     | 17,239             | 4,028                       | 8,049              |
| Other expense - Exited Lines          | 2,523                     | 4,005              | 1,184                       | 2,196              |
| Other expense - Corporate             | 31,138                    | 28,006             | 15,773                      | 13,427             |
| Interest expense                      | 12,843                    | 12,844             | 6,457                       | 6,042              |
| Foreign currency expense (benefit)    | (9,045)                   | (1,440)            | 1,939                       | (4,205)            |
| <b>Total expense</b>                  | <b>46,082</b>             | <b>60,654</b>      | <b>29,381</b>               | <b>25,509</b>      |
| <b>Pretax loss</b>                    | <b>\$ (36,294)</b>        | <b>\$ (39,090)</b> | <b>\$ (24,895)</b>          | <b>\$ (14,695)</b> |

The 2012 amounts for net earned premium, loss and loss adjustment expense, and other expense Exited Lines have been adjusted to reflect the addition of two product lines previously included in the Accident & Health segment. Net earned premium decreased year-over-year as we wrote less business related to our exited HMO and medical excess reinsurance products. Premium related to the other products included in Exited Lines was insignificant in all periods. The majority of the loss and loss adjustment expense relates to the HMO and medical excess reinsurance products.

Our Corporate expenses not allocable to the segments increased \$3.1 million in the first six months of 2013, primarily due to higher employee compensation and benefit costs. The impact of foreign currency benefit/expense fluctuated period-over-period principally due to changes in the value of the British pound sterling and the Euro relative to the U.S. dollar. We hold available for sale securities denominated in non-functional currencies to economically hedge the currency exchange risk on our loss reserves denominated in non-functional currencies. The foreign

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

currency benefit/expense related to loss reserves is recorded through the income statement, while the foreign currency benefit/expense related to available for sale securities is recorded through other comprehensive income within shareholders' equity. This accounting mismatch may cause fluctuations in our reported foreign currency benefit/expense in future periods.

**Table of Contents****Liquidity and Capital Management**

We believe we have sufficient sources of liquidity at both a consolidated and insurance company legal entity level at a reasonable cost to pay claims and meet our other contractual obligations and liabilities as they become due in the short-term and long-term. Our current sources of liquidity include: 1) significant operating cash flow generated by our insurance companies, 2) a \$6.7 billion investment portfolio, most of which is held by our insurance companies, 3) our revolving loan and standby letter of credit facilities and 4) a \$1.0 billion shelf registration. Our insurance companies have sufficient resources to pay potential claims. Based on historical payment patterns and claims history, at year-end 2012, we projected that our insurance companies will pay approximately \$1.4 billion of claims in 2013. We also projected that they will collect approximately \$0.4 billion of reinsurance recoveries in 2013. In addition to expected cash flow from their 2013 operations, these companies had \$6.4 billion of investments available to fund claims payments, if needed. Our sources of liquidity are discussed below.

***Cash Flow***

We manage the liquidity of our insurance companies such that each subsidiary's anticipated claims payments will be met by its own current operating cash flows, cash, short-term investments or investment maturities. Our insurance companies receive substantial cash from premiums, reinsurance recoverables, surety collateral, outward commutations, proceeds from sales and redemptions of investments, and investment income. Their 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, policy acquisition costs, operating expenses, taxes and dividends paid to the parent company. We report all of the insurance companies' investing activity in our Investing segment for segment reporting purposes. Our parent company's principal cash inflows relate to its investment portfolio and dividends paid by the insurance companies, and its principal cash outflows relate to debt service, operating expenses, dividends paid to shareholders 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.

The components of our net operating cash flows are summarized in the following table.

|  | <b>Six months ended June 30,</b> |                   |
|--|----------------------------------|-------------------|
|  | <b>2013</b>                      | <b>2012</b>       |
| Net earnings   | \$ 194,012                       | \$ 176,077        |
| Change in premium, claims and other receivables, net of reinsurance, premium and claims payables and excluding restricted cash | (56,660)                         | (64,793)          |
| Change in unearned premium, net  | 84,727                           | 83,497            |
| Change in loss and loss adjustment expense payable, net of reinsurance recoverables  | 35,008                           | 87,846            |
| Change in accounts payable and accrued liabilities   | (119,103)                        | (44,867)          |
| Gain on investments  | (13,193)                         | (6,650)           |
| Other, net   | (22,801)                         | 13,441            |
| <b>Cash provided by operating activities</b>   | <b>\$ 101,990</b>                | <b>\$ 244,551</b> |

Our cash provided by operating activities was \$102.0 million in the first six months of 2013, compared to \$244.6 million in the same period of 2012. Cash provided by operating activities includes collateral funds we receive or refund for our U.S. surety business, as well as funds we pay to commute large contracts. We refunded surety collateral of \$74.3 million in 2013 and \$21.2 million in 2012 and also paid \$27.5 million in 2012 to commute a large contract in our Exited Lines. The remaining \$117.0 million reduction in our cash provided by operating activities primarily resulted from \$60.5 million of higher income tax payments in the first six months of 2013, compared to 2012, as well as the timing of the collection and the payment of insurance-related receivables and payables.

## **Table of Contents**

### ***Investments***

At June 30, 2013, we held a \$6.7 billion investment portfolio, which included \$216.8 million of liquid short-term investments. Our fixed maturity and equity securities portfolio is classified as available for sale. We expect to hold our fixed maturity securities until maturity, but we would be able to sell these securities, as well as our equity securities and other investments, to generate cash if needed. See the Investing Segment section above for additional information about our investment portfolio. The parent company held \$413.6 million of cash and investments, which are available to cover the holding company's required cash disbursements in 2013.

### ***Revolving Loan and Standby Letter of Credit Facilities***

We maintain a \$600.0 million Revolving Loan Facility (Facility), of which \$253.6 million of available capacity remained at June 30, 2013. During the past several years, we used the Facility to fund purchases of our common stock, which we expect to continue to do as we opportunistically repurchase stock in 2013. On April 26, 2013, we entered into an agreement to modify the Facility. Under the amended agreement, the Facility expires on April 26, 2017. We also have a \$90.0 million Standby Letter of Credit Facility (Standby Facility) that is used to guarantee our performance in our Lloyd's of London syndicate. The Standby Facility expires in 2016. See Note 7, Notes Payable to the Consolidated Financial Statements for additional information related to the Facility and Standby Facility and our long-term indebtedness.

### ***Share Purchases***

On August 23, 2012, the Board approved the purchase of up to \$300.0 million of our common stock (the Plan). Purchases under the Plan 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 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 2013, we purchased \$12.1 million, or 0.3 million shares, at an average cost of \$41.94 per share. We purchased \$40.9 million, or 1.0 million shares, at an average cost of \$39.96 per share in the first six months of 2013. As of July 26, 2013, \$208.9 million of repurchase authority remains under the Plan.

### ***Shelf Registration***

We have a Universal Shelf registration statement that expires in March 2015. The Universal Shelf provides for the issuance of \$1.0 billion of securities, which may be debt securities, equity securities, or a combination thereof. The Universal Shelf provides us the means to access the debt and equity markets relatively quickly, if we are satisfied with the current pricing in the financial markets.

### **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, 2012. We have made no changes in the identification or methods of application of these policies; however, the following information supplements the Reserves disclosures on page 55 of our Annual Report on Form 10-K for the year ended December 31, 2012.

Our recorded reserves represent management's best estimate of unpaid losses and loss adjustment expenses as of each quarter end, based on information, facts and circumstances known at that time. The process of establishing reserves is complex, imprecise and inherently uncertain and, as such, involves a considerable degree of judgment involving our management review and actuarial processes. We must consider many variables that are subject to the outcome of future events. As a result, an integral component of our loss reserving process is the use of informed subjective estimates and judgments about our ultimate exposure to losses. Therefore, it is possible that management's estimate of the ultimate liability for losses may change.

## **Table of Contents**

Management considers many factors in determining the ultimate losses and reserves for the various products in our five insurance underwriting segments. These factors include: 1) actuarial point estimates and the estimated ranges around these estimates, 2) information used to price the applicable policies, 3) historical loss information, where available, 4) public industry data for the product or similar products, 5) an assessment of current market conditions, 6) information on individual claims, 7) an assessment of current or potential litigation involving claims and 8) information from underwriting and claims personnel. The estimate of our reserves is increased or decreased as more information becomes known about the frequency and severity of losses for prior and current years. We believe our review process is effective, such that any required changes in reserves are recognized in the period of change as soon as the need for the change is evident.

Our actuaries monitor the adequacy and reasonableness of our recorded reserves for over 100 specialty insurance products by accident year or underwriting year, as applicable. The table on page 57 of our Annual Report on Form 10-K for the year ended December 31, 2012 details the characteristics for our major products in each segment. Although the duration (the time period between the occurrence of a loss and the settlement of a claim) is either short-term or medium-term for the majority of these products, approximately 50% of our total gross reserves at December 31, 2012 related to long-tail products in our Professional Liability and International segments and our Exited Lines. These long-tail products include directors and officers liability, large account E&O liability, International accident and health, and assumed accident and health reinsurance business that we no longer write. We write many of these contracts as excess insurance, where losses in lower layers must develop first before our excess coverage attaches. Significant periods of time, ranging up to several years or more, may elapse between occurrence of the loss, reporting of the loss to us, and settlement of the claim. In addition, many of these claims are susceptible to litigation and can be affected by escalating legal defense costs, contract interpretations and the changing economic and legal environment. As a result, our long-tail products are subject to greater levels of reserve volatility, creating favorable or adverse loss development over a longer period of time.

Our actuaries perform a comprehensive review of loss reserves for each major product at least once each year. The reviews take into consideration the variety of trends that impact the ultimate settlement of claims for each product type. These reviews follow a pre-set schedule, which covers the product lines in each segment, as follows: 1) second quarter Exited Lines, 2) third quarter U.S. Property & Casualty and Professional Liability and 3) fourth quarter Accident & Health, U.S. Surety & Credit, and International. In addition to these comprehensive reviews, each quarter the actuaries review the emergence of paid and reported losses relative to expectations (established during the annual reviews) for all product lines and, if considered necessary, perform a more detailed review of the particular reserves.

Our actuaries' loss review process relies on the basic assumption that past experience, adjusted for the effects of current developments and likely trends, is a reasonable basis for predicting future outcomes. As part of their process, our actuaries use a variety of actuarial methods that analyze experience, trends and other relevant factors. The principal standard actuarial methods used by our actuaries for their comprehensive reviews include:

**Loss ratio method** This method uses loss ratios for prior accident years, adjusted for current trends, to determine an appropriate expected loss ratio for a given accident year.

**Loss development methods** Loss development methods assume that the losses yet to emerge for an accident year are proportional to the paid or reported loss amounts observed to-date. The paid loss development method uses losses paid to-date, while the reported loss development method uses losses reported to-date.

**Bornheutter-Ferguson method** This method is a combination of the loss ratio and loss development methods, where the loss development factor is given more weight as an accident year matures.

**Frequency/severity method** This method projects claim counts and average cost per claim on a paid or reported basis for high frequency, low severity products.

Our actuaries calculate an actuarial point estimate, as well as a high and low end of the actuarial range, for the products that they review. The actuarial point estimates represent our actuaries' estimate of the most likely amount that will ultimately be paid to settle the net reserves we have recorded at a particular point in time. While standard actuarial techniques are utilized in making these actuarial point estimates, these techniques require a high degree of judgment, and changing conditions can cause fluctuations in the reserve estimates. While, from an actuarial standpoint, a point estimate is considered the most likely amount to be paid, there is inherent uncertainty in the point estimate, and it can be thought of as the expected value in a distribution of possible reserve estimates. The actuarial ranges represent our actuaries' estimate of a likely lowest amount and highest amount that will ultimately be paid to settle the net reserves. There is still a possibility of ultimately paying an amount below the range or above the range. The range determinations are based on estimates and actuarial judgments and are intended to encompass reasonably likely changes in one or more of the variables that were used to determine the point estimates.

## **Table of Contents**

Management evaluates the adequacy of our recorded consolidated reserves at each reporting period and approves increases or decreases in reserves, as considered necessary, based on a consideration of all material facts and circumstances known at that time. The Reserve Review Committee (which includes our CEO, President, CFO, executive management, chief actuary, segment management, and key actuarial, claims and accounting personnel) meets each quarter to review our actuaries' comprehensive review of loss reserves and assessment of the emergence of paid and reported losses relative to expectations. The Reserve Review Committee discusses factors impacting the reserves in that quarter, for each insurance segment, including the most recent actuarial point and range estimates to monitor the adequacy and reasonableness of the recorded reserves. If the recorded reserves vary significantly from the actuarial point estimate, management discusses the reasons for the variances. Based on the discussions during this meeting, and any additional subsequent meetings, the Reserve Review Committee determines whether any recorded reserves should be increased or decreased during the quarter to an amount that, in management's judgment, is adequate based on all of the facts and circumstances considered, including the actuarial point estimates. Historically, our consolidated net reserves at each quarter-end have been above the total actuarial point estimate and within the actuarial range.

Any increase or decrease in prior years' reserves approved by the Reserve Review Committee generates favorable or adverse loss development related to our ultimate losses, which is reflected in our incurred but not reported (IBNR) reserves in the period of the reserve change. In addition, we may have loss development due to the normal claims settlement process. For our most recent accident years, recorded loss reserves are generally based on management's establishment of ultimate loss ratios for each product line, based on historical loss trends and current market considerations. We do not recognize favorable or adverse development for these recent accident years until loss trends emerge. The time required for credible loss trends to emerge differs based on the characteristics of the product, and with long-tail products this can take several years. Over time, our recorded reserves align closer to the actuarial indications as we place additional weight on the credibility of assumptions relating to actual experience and claims outstanding, which may result in favorable or adverse development.

### **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, 2012.

### **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, 2013 using criteria established in the *Internal Control - Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective in providing reasonable assurance of achieving the purposes described in Rule 13a-15(e) under the Act as of June 30, 2013.

#### **(b) Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2013 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, individually or in the aggregate, 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, 2012.

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

On August 23, 2012, the Board approved the purchase of up to \$300.0 million of our common stock (the Plan). Purchases under the Plan 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, 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. Our purchases in the second quarter of 2013 were as follows:

|               |   |   | <b>Total number of shares<br/>purchased as part of<br/>publicly announced<br/>plans or programs</b> | <b>Approximate dollar<br/>value of shares that may<br/>yet be purchased under<br/>the plans or programs</b> |
|---------------|---|---|---|---|
| <b>Period</b> | <b>Total number of<br/>shares purchased</b> | <b>Average price<br/>paid per share</b> |   |   |
| April         | 56,226                                      | \$41.12                                 | 56,226  | \$218,703,258   |
| May           | 25,088                                      | \$42.03                                 | 25,088  | \$217,648,892   |
| June          | 208,657                                     | \$42.15                                 | 208,657   | \$208,855,025   |

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

---

**Table of Contents**

**Item 6. Exhibits**

**Exhibit  
Number**

- 3.1 Restated Certificate of Incorporation and Amendment of Certificate of Incorporation of HCC Insurance Holdings, Inc., filed with Delaware Secretary of State on July 23, 1996 and May 21, 1998, respectively (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (Registration No. 333-61687) filed on August 17, 1998).
- 3.2 Third Amended and Restated Bylaws of HCC Insurance Holdings, Inc. (incorporated by reference to Exhibit 3.1 to Current Report on Form 8-K filed on March 18, 2013).
- 4.1 Indenture, dated August 23, 2001, between HCC Insurance Holdings, Inc. and First Union National Bank related to Debt Securities (Senior Debt) (incorporated by reference to Exhibit 4.1 to 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 6.30% Senior Notes due 2019 (incorporated by reference to Exhibit 4.2 to Current Report on Form 8-K filed on November 13, 2009).
- 10.1 Second Amendment to Loan Agreement, dated April 26, 2013, among HCC Insurance Holdings, Inc., Wells Fargo Bank, National Association, as Administrative Agent, Barclays Bank PLC and Bank of America, N.A., as Co-Syndication Agents, JPMorgan Chase Bank, N.A. and The Royal Bank of Scotland PLC, as Co-Documentation Agents, and the other lenders party thereto (incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed on April 30, 2013).
- 12 Statement of Ratios.
- 31.1 Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following financial statements from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2013 formatted in XBRL: 1) Consolidated Balance Sheets, 2) Consolidated Statements of Earnings, 3) Consolidated Statements of Comprehensive Income, 4) Consolidated Statement of Changes in Shareholders' Equity, 5) Consolidated Statements of Cash Flows and 6) Notes to Consolidated Financial Statements.

Filed herewith.

**Table of Contents**

**SIGNATURES**

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

HCC Insurance Holdings, Inc.  
(Registrant)

August 2, 2013  
(Date)

/s/ Christopher J.B. Williams  
Christopher J.B. Williams,  
Chief Executive Officer

August 2, 2013  
(Date)

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