

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

May 09, 2008

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

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period Ended March 31, 2008.**

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

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

(Exact name of registrant as specified in its charter)

Delaware

76-0336636

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

13403 Northwest Freeway, Houston, Texas

77040-6094

(Address of principal executive offices)

(Zip Code)

(713) 690-7300

(Registrant's telephone number, including area code)

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the 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 April 30, 2008, there were approximately 115.3 million shares of common stock, \$1.00 par value issued and outstanding.

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**FORWARD-LOOKING STATEMENTS**

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

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

*the effects of catastrophic losses;*

*the cyclical nature of the insurance business;*

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

*the effects of emerging claim and coverage issues;*

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

*potential credit risk with brokers;*

*our assessment of underwriting risk;*

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

*the adequacy of reinsurance protection;*

*the ability or willingness of reinsurers to pay balances due us;*

*the occurrence of terrorist activities;*

*our ability to maintain our competitive position;*

*changes in our assigned financial strength ratings;*

*our ability to raise capital in the future;*

*attraction and retention of qualified employees;*

*fluctuations in securities markets, which may reduce the value of our investment assets;*

*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;*

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*failures of our information technology systems;*

*developments in the SEC's inquiry related to our past stock option granting procedures; and*

*change of control.*

*We describe these risks and uncertainties in greater detail in Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007.*

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

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

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

	March 31, 2008	December 31, 2007
<b>ASSETS</b>		
Investments:		
Fixed income securities, at fair value (amortized cost: 2008 - \$3,903,397, 2007 - \$3,641,667)	\$ 3,929,549	\$ 3,666,705
Short-term investments, at cost, which approximates fair value	655,598	783,650
Other investments	214,555	221,922
<b>Total investments</b>	<b>4,799,702</b>	<b>4,672,277</b>
Cash	24,688	39,135
Restricted cash and cash investments	180,754	193,151
Premium, claims and other receivables	775,126	763,401
Reinsurance recoverables	953,925	956,665
Ceded unearned premium	224,785	244,684
Ceded life and annuity benefits	65,892	66,199
Deferred policy acquisition costs	194,957	192,773
Goodwill	817,372	776,046
Other assets	181,217	170,314
<b>Total assets</b>	<b>\$ 8,218,418</b>	<b>\$ 8,074,645</b>
<b>LIABILITIES</b>		
Loss and loss adjustment expense payable	\$ 3,318,811	\$ 3,227,080
Life and annuity policy benefits	65,892	66,199
Reinsurance balances payable	124,077	129,838
Unearned premium	926,940	943,946
Deferred ceding commissions	62,562	68,968
Premium and claims payable	442,379	497,974
Notes payable	364,714	324,714
Accounts payable and accrued liabilities	390,849	375,561
<b>Total liabilities</b>	<b>5,696,224</b>	<b>5,634,280</b>
<b>SHAREHOLDERS EQUITY</b>		
Common stock, \$1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2008 115,298; 2007 115,069)	115,298	115,069
Additional paid-in capital	838,648	831,419
Retained earnings	1,514,414	1,445,995

Accumulated other comprehensive income	53,834	47,882
<b>Total shareholders equity</b>	<b>2,522,194</b>	<b>2,440,365</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 8,218,418</b>	<b>\$ 8,074,645</b>

See Notes to Condensed Consolidated Financial Statements.

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

	Three months ended March 31,	
	2008	2007
<b>REVENUE</b>		
Net earned premium	\$ 493,546	\$ 497,600
Fee and commission income	30,999	32,125
Net investment income	47,621	49,467
Net realized investment gain (loss)	168	(555)
Other operating income (loss)	(4,946)	18,585
<b>Total revenue</b>	<b>567,388</b>	<b>597,222</b>
<b>EXPENSE</b>		
Loss and loss adjustment expense, net	293,026	300,472
Policy acquisition costs, net	92,268	89,099
Other operating expense	59,204	57,641
Interest expense	3,959	3,303
<b>Total expense</b>	<b>448,457</b>	<b>450,515</b>
Earnings before income tax expense	118,931	146,707
Income tax expense	37,830	50,017
<b>Net earnings</b>	<b>\$ 81,101</b>	<b>\$ 96,690</b>
<b>Basic earnings per share data:</b>		
Net earnings per share	\$ 0.70	\$ 0.86
Weighted average shares outstanding	115,234	111,959
<b>Diluted earnings per share data:</b>		
Net earnings per share	\$ 0.70	\$ 0.83

Weighted average shares outstanding	116,372	117,009
Cash dividends declared, per share	\$ 0.11	\$ 0.10

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries  
 Condensed Consolidated Statement of Changes in Shareholders' Equity  
 Three months ended March 31, 2008  
 (unaudited, in thousands except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total shareholders equity
<b>Balance at December 31, 2007</b>	\$ 115,069	\$ 831,419	\$ 1,445,995	\$ 47,882	\$ 2,440,365
Net earnings			81,101		81,101
Other comprehensive income				5,952	5,952
Comprehensive income					87,053
Issuance of 219 shares for exercise of options, including tax benefit of \$351	219	4,373			4,592
Stock-based compensation	10	2,856			2,866
Cash dividends declared, \$0.11 per share			(12,682)		(12,682)
<b>Balance at March 31, 2008</b>	\$ 115,298	\$ 838,648	\$ 1,514,414	\$ 53,834	\$ 2,522,194

See Notes to Condensed Consolidated Financial Statements.

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

	Three months ended March 31,	
	2008	2007
Cash flows from operating activities:		
Net earnings	\$ 81,101	\$ 96,690
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Change in premium, claims and other receivables	3,779	87,166
Change in reinsurance recoverables	2,671	111,267
Change in ceded unearned premium	19,899	1,890
Change in loss and loss adjustment expense payable	91,845	16,445
Change in reinsurance balances payable	(5,761)	(8,325)
Change in unearned premium	(16,960)	(2,622)
Change in premium and claims payable, net of restricted cash	(45,449)	(86,687)
Change in trading portfolio	9,062	10,958
Depreciation and amortization expense	3,390	3,736
Stock-based compensation expense	2,866	2,211
Other, net	(10,643)	(2,418)
<b>Cash provided by operating activities</b>	<b>135,800</b>	<b>230,311</b>
Cash flows from investing activities:		
Sales of fixed income securities	120,075	28,483
Maturity or call of fixed income securities	75,875	70,148
Cost of securities acquired	(455,973)	(367,195)
Change in short-term investments	128,052	24,857
Sales of other investments	19,038	
Sale of strategic investments		22,950
Payments for purchase of subsidiaries, net of cash received	(71,486)	(5,917)
Other, net	(1,670)	(2,168)
<b>Cash used by investing activities</b>	<b>(186,089)</b>	<b>(228,842)</b>
Cash flows from financing activities:		
Advances on line of credit	40,000	11,000
Payments on line of credit and notes payable		(11,339)
Sale of common stock	4,592	8,040
Dividends paid	(12,658)	(11,173)
Other, net	3,908	(3,795)
<b>Cash provided (used) by financing activities</b>	<b>35,842</b>	<b>(7,267)</b>
Net decrease in cash	(14,447)	(5,798)

Cash at beginning of period	39,135	48,290
<b>Cash at end of period</b>	<b>\$ 24,688</b>	<b>\$ 42,492</b>

See Notes to Condensed Consolidated Financial Statements.

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

**(1) GENERAL INFORMATION**

HCC Insurance Holdings, Inc. and its subsidiaries (collectively, we, us or our) include domestic and foreign property and casualty and life insurance companies, underwriting agencies and reinsurance brokers. We provide specialized property and casualty, surety, and group life, accident and health insurance coverages and related agency and reinsurance brokerage services to commercial customers and individuals. We market our products both directly to customers and through a network of independent and affiliated brokers, producers, agents and third party administrators. Our lines of business include diversified financial products (which includes directors and officers liability, professional indemnity, employment practices liability, surety and credit); group life, accident and health; aviation; our London market account (which includes energy, marine, property, and accident and health); and other specialty lines of insurance. We operate primarily in the United States, the United Kingdom, Spain, Bermuda, Belgium and Ireland, although some of our operations have a broader international scope.

**Basis of Presentation**

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments that, in our opinion, are necessary for a fair presentation of results of the interim periods, and all such adjustments are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The condensed consolidated financial statements should be read in conjunction with our annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet at December 31, 2007 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

Management must make estimates and assumptions that affect amounts reported in our condensed consolidated financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates.

**Acquisitions**

On January 2, 2008, we acquired MultiNational Underwriters, LLC, an underwriting agency located in Indianapolis, Indiana, for \$42.7 million in cash and a possible additional earnout depending upon future underwriting profit levels. This agency writes domestic and international short-term medical insurance. The results of operations of MultiNational Underwriters were included in our condensed consolidated financial statements beginning on the effective date of the transaction. We valued all identifiable assets and liabilities at fair value and allocated \$39.4 million to goodwill in our initial purchase price allocation. We are still in the process of valuing certain agreements to complete our purchase price allocation. Goodwill resulting from this acquisition will be deductible for United States Federal income tax purposes.

On November 1, 2007, we acquired Ponderosa Management, Inc., the parent company of Pioneer Insurance Company, for \$12.2 million in cash. During the first quarter, we completed our purchase price allocation, resulting in final goodwill of \$4.5 million.

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**Income Tax**

For the three months ended March 31, 2008 and 2007, the income tax provision was calculated based on an estimated effective tax rate for each fiscal year. Our effective tax rate differs from the United States Federal statutory rate primarily due to tax-exempt municipal bond interest and state income taxes.

**Stock-Based Compensation**

In the first quarter of 2008, we granted 10,000 shares of restricted stock and options for the purchase of 180,000 shares of our common stock at \$22.02 per share. The aggregate fair value of these awards was \$0.9 million, which will be expensed over a vesting period of three to five years.

**Recent Accounting Pronouncements**

The Financial Accounting Standards Board (FASB) has issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, to delay the effective date of SFAS No. 157, *Fair Value Measurements*, (discussed in Note 2 below) for nonfinancial assets and nonfinancial liabilities measured at fair value on a nonrecurring basis. For these items, FSP 157-2 will be effective January 1, 2009. We are evaluating what impact these future additional SFAS 157 requirements will have on our consolidated financial statements.

SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, issued by the FASB, became effective January 1, 2008. SFAS 159 allows a company to make an irrevocable election to measure eligible financial assets and financial liabilities at fair value that are not otherwise measured at fair value. Unrealized gains and losses for those items are reported in current earnings at each subsequent reporting date. As of January 1, 2008, we have not elected to value any additional assets or liabilities at fair value under the guidance of SFAS 159.

The FASB has issued SFAS No. 141 (revised 2007) (SFAS 141(R)), *Business Combinations*, and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, an amendment of Accounting Research Bulletin No. 51. SFAS 141(R) will change the accounting treatment for business combinations and will impact presentation of financial statements on the acquisition date and accounting for acquisitions in subsequent periods. SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of shareholders' equity. SFAS 141(R) and SFAS 160 will be effective January 1, 2009 and early adoption is not permitted. We are evaluating the impact SFAS 141(R) and SFAS 160 will have on our consolidated financial statements.

The FASB has issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133*, which expands the required disclosures about a company's derivative and hedging activities. SFAS 161 will be effective January 1, 2009. We are evaluating the impact SFAS 161 will have on the notes to our consolidated financial statements.

**(2) FAIR VALUE MEASUREMENTS**

Effective January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements*, for financial assets and financial liabilities measured at fair value on a recurring basis (at least annually). SFAS 157 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. Our adoption of SFAS 157 did not impact our 2008 or prior years' consolidated financial position,

results of operations or cash flows.



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SFAS 157 applies to all financial instruments that are measured and reported at fair value. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 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. The degree of judgment used to measure fair value generally correlates to the type of pricing and other data used as inputs, or assumptions, in the valuation process. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our own market assumptions using the best information available to us. Based on the type of inputs used to measure the fair value of our financial instruments, we classify them into the following three-level hierarchy established by SFAS 157:

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 instruments are primarily U.S. Treasuries and equity securities listed on stock exchanges.

Our Level 2 instruments include most of our fixed income securities, which consist of U.S. government and agency securities, municipal bonds, certain corporate debt securities, and certain mortgage and asset-backed securities. Our Level 2 instruments also include our interest rate swap agreements, which were reflected as liabilities in our consolidated balance sheet at March 31, 2008. We obtain fair value measurements for the majority of our Level 2 instruments from an independent pricing service. The fair value measurements consider various 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. To validate the independent pricing service's fair values, we obtain the fair value for our fixed income securities from third party investment managers and compare the two sources of each security's fair value for reasonableness. In addition, we obtain an understanding of the methods used by the independent pricing service. When fair value measurements are not available from our independent pricing service, we use fair value measurements provided by third party investment managers, which are modeled using valuation methodologies and observable inputs similar to those listed above.

Our Level 3 securities include certain fixed income securities, a short-term investment with extended repayment terms, and two insurance contracts that we account for as derivatives. We determine the fair value for Level 3 instruments based on internally developed models that use assumptions or other data that are not readily observable from objective sources. Because we use the lowest level significant input to determine our hierarchy classifications, a financial instrument may be classified in Level 3 even though there may be significant readily-observable inputs. We have excluded from our SFAS 157 disclosures certain assets, such as alternative investments and certain strategic investments in insurance-related companies, since we account for them using the equity method of accounting and have not elected to measure them at fair value, pursuant to the guidance of SFAS 159. These assets had a recorded value of approximately \$175.2 million at March 31, 2008.

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The following table presents our assets and liabilities that are measured at fair value as of March 31, 2008.

	Level 1	Level 2	Level 3	Total
Fixed income securities	\$ 96,377	\$ 3,826,224	\$ 6,948	\$ 3,929,549
Short-term investments		113,646		113,646
Other investments	51,151		3,576	54,727
Other assets	19,856		18,136	37,992
<b>Total assets</b>	<b>\$ 167,384</b>	<b>\$ 3,939,870</b>	<b>\$ 28,660</b>	<b>\$ 4,135,914</b>
Accounts payable and accrued liabilities	\$	\$ 7,017	\$	\$ 7,017
<b>Total liabilities</b>	<b>\$</b>	<b>\$ 7,017</b>	<b>\$</b>	<b>\$ 7,017</b>

The following table presents the changes in fair value of our Level 3 category for the first quarter of 2008.

	Fixed income securities	Other investments	Other assets	Total
<b>Balance at January 1, 2008</b>	<b>\$ 7,623</b>	<b>\$ 5,492</b>	<b>\$ 16,804</b>	<b>\$ 29,919</b>
Net redemptions	(239)	(1,875)		(2,114)
Gains and (losses) unrealized	(436)	(41)	1,332	855
<b>Balance at March 31, 2008</b>	<b>\$ 6,948</b>	<b>\$ 3,576</b>	<b>\$ 18,136</b>	<b>\$ 28,660</b>

Unrealized gains and losses on our Level 3 fixed income securities and other investments are reported in other comprehensive income within shareholders' equity, and unrealized gains and losses on our Level 3 other assets are reported in other operating income.

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**(3) REINSURANCE**

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

	Written premium	Earned premium	Loss and loss adjustment expense
<u>Three months ended March 31, 2008</u>			
Direct business	\$ 483,146	\$ 511,623	\$ 292,811
Reinsurance assumed	99,853	93,070	69,272
Reinsurance ceded	(89,352)	(111,147)	(69,057)
<b>Net amounts</b>	<b>\$ 493,647</b>	<b>\$ 493,546</b>	<b>\$ 293,026</b>

Three months ended March 31, 2007

Direct business	\$ 458,502	\$ 485,370	\$ 287,451
Reinsurance assumed	140,599	116,473	62,997
Reinsurance ceded	(102,136)	(104,243)	(49,976)
<b>Net amounts</b>	<b>\$ 496,965</b>	<b>\$ 497,600</b>	<b>\$ 300,472</b>

Ceding commissions netted against policy acquisition costs in the condensed consolidated statements of earnings were \$11.7 million in 2008 and \$11.2 million in 2007.

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

	March 31, 2008	December 31, 2007
Reinsurance recoverable on paid losses	\$ 72,913	\$ 80,915
Reinsurance recoverable on outstanding losses	463,624	458,190
Reinsurance recoverable on incurred but not reported losses	425,832	426,090
Reserve for uncollectible reinsurance	(8,444)	(8,530)
<b>Total reinsurance recoverables</b>	<b>\$ 953,925</b>	<b>\$ 956,665</b>



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Our reserve for uncollectible reinsurance covers potential collectibility issues, including disputed amounts and associated expenses. While we believe the reserve is adequate based on information currently available, market conditions may change or additional information might be obtained that may require us to change the reserve in the future. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

Our U.S. domiciled insurance companies require reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize their reinsurance obligations due to us. The table below shows the amounts of letters of credit and cash deposits held by us as collateral, plus other credits available for potential offset.

	March 31, 2008	December 31, 2007
Payables to reinsurers	\$ 252,564	\$ 246,745
Letters of credit	181,298	188,400
Cash deposits	104,436	114,549
<b>Total credits</b>	<b>\$ 538,298</b>	<b>\$ 549,694</b>

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

	March 31, 2008	December 31, 2007
Loss and loss adjustment expense payable	\$ 3,318,811	\$ 3,227,080
Reinsurance recoverable on outstanding losses	(463,624)	(458,190)
Reinsurance recoverable on incurred but not reported losses	(425,832)	(426,090)
<b>Net reserves</b>	<b>\$ 2,429,355</b>	<b>\$ 2,342,800</b>
Unearned premium	\$ 926,940	\$ 943,946
Ceded unearned premium	(224,785)	(244,684)
<b>Net unearned premium</b>	<b>\$ 702,155</b>	<b>\$ 699,262</b>
Deferred policy acquisition costs	\$ 194,957	\$ 192,773
Deferred ceding commissions	(62,562)	(68,968)
<b>Net deferred policy acquisition costs</b>	<b>\$ 132,395</b>	<b>\$ 123,805</b>



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

**(4) EARNINGS PER SHARE**

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

	Three months ended March	
	2008	2007
Net earnings	\$ 81,101	\$ 96,690
Weighted average common shares outstanding	115,234	111,959
Dilutive effect of restricted stock and outstanding options (determined using the treasury stock method)	533	1,008
Dilutive effect of convertible debt (determined using the treasury stock method)	605	4,042
<b>Weighted average common shares and potential common shares outstanding</b>	<b>116,372</b>	<b>117,009</b>
Anti-dilutive stock options not included in treasury stock method computation	5,622	2,229

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**(5) SEGMENT AND GEOGRAPHIC INFORMATION**

The performance of each segment is evaluated by our management based on net earnings. Net earnings is calculated after tax and after allocation of certain corporate expenses and certain intercompany interest. All stock-based compensation expense, unallocated corporate expenses and unallocated interest expense are included in the corporate segment since these costs are not included in management's evaluation of the other segments. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated.

	Insurance Company	Agency	Other Operations	Corporate	Total
<u>Three months ended March 31, 2008</u>					
Revenue:					
Domestic	\$ 456,928	\$ 13,951	\$ (6,245)	\$ 332	\$ 464,966
Foreign	92,697	9,725			102,422
Inter-segment		17,109			17,109
<b>Total segment revenue</b>	<b>\$ 549,625</b>	<b>\$ 40,785</b>	<b>\$ (6,245)</b>	<b>\$ 332</b>	<b>584,497</b>
Inter-segment eliminations					(17,109)
<b>Consolidated total revenue</b>					<b>\$ 567,388</b>
Net earnings (loss):					
Domestic	\$ 66,730	\$ 4,685	\$ (5,080)	\$ (7,667)	\$ 58,668
Foreign	20,856	421			21,277
<b>Total segment net earnings (loss)</b>	<b>\$ 87,586</b>	<b>\$ 5,106</b>	<b>\$ (5,080)</b>	<b>\$ (7,667)</b>	<b>79,945</b>
Inter-segment eliminations					1,156
<b>Consolidated net earnings</b>					<b>\$ 81,101</b>
Other items:					
Net investment income	\$ 45,756	\$ 1,553	\$ 17	\$ 295	\$ 47,621
Depreciation and amortization	1,181	1,491	35	683	3,390



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Interest expense	131	2,506	(26)	1,348	3,959
Capital expenditures	651	1,228	2	779	2,660
Income tax expense (benefit)	38,570	3,545	(3,711)	(1,280)	37,124
Inter-segment eliminations					706

Consolidated income tax expense \$ 37,830

During 2008, the other operations segment recorded an after-tax loss of \$5.9 million from the reduction in market value of our two trading securities.

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	Insurance Company	Agency	Other Operations	Corporate	Total
<u>Three months ended March 31, 2007</u>					
Revenue:					
Domestic	\$ 458,760	\$ 14,957	\$ 18,276	\$ 397	\$ 492,390
Foreign	94,809	10,023			104,832
Inter-segment		13,986			13,986
<b>Total segment revenue</b>	<b>\$ 553,569</b>	<b>\$ 38,966</b>	<b>\$ 18,276</b>	<b>\$ 397</b>	<b>611,208</b>
Inter-segment eliminations					(13,986)
<b>Consolidated total revenue</b>					<b>\$ 597,222</b>
Net earnings (loss):					
Domestic	\$ 66,795	\$ 4,704	\$ 11,379	\$ (6,085)	\$ 76,793
Foreign	17,381	221			17,602
<b>Total segment net earnings (loss)</b>	<b>\$ 84,176</b>	<b>\$ 4,925</b>	<b>\$ 11,379</b>	<b>\$ (6,085)</b>	<b>94,395</b>
Inter-segment eliminations					2,295
<b>Consolidated net earnings</b>					<b>\$ 96,690</b>
Other items:					
Net investment income	\$ 45,765	\$ 2,438	\$ 987	\$ 277	\$ 49,467
Depreciation and amortization	1,179	1,746	112	699	3,736
Interest expense	464	2,765	30	44	3,303
Capital expenditures	1,028	654		486	2,168
Income tax expense (benefit)	40,081	4,472	6,490	(2,537)	48,506
Inter-segment eliminations					1,511
Consolidated income tax expense					\$ 50,017

During 2007, the other operations segment recorded an after-tax gain of \$7.0 million from the sale of a strategic investment.

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The following tables present selected revenue items by line of business.

	Three months ended March 31,	
	2008	2007
Diversified financial products	\$ 192,177	\$ 192,514
Group life, accident and health	192,446	192,416
Aviation	34,993	39,344
London market account	27,090	33,896
Other specialty lines	46,846	39,738
Discontinued lines	(6)	(308)
<b>Net earned premium</b>	<b>\$ 493,546</b>	<b>\$ 497,600</b>
Property and casualty	\$ 25,254	\$ 27,475
Accident and health	5,745	4,650
<b>Fee and commission income</b>	<b>\$ 30,999</b>	<b>\$ 32,125</b>

**(6) SUPPLEMENTAL INFORMATION**

Supplemental cash flow information was as follows.

	Three months ended March 31,	
	2008	2007
Cash received from commutations	\$ 7,500	\$ 101,040
Income taxes paid	16,111	10,385
Interest paid	4,091	3,318
Comprehensive income	87,053	91,298

**(7) COMMITMENTS AND CONTINGENCIES****Litigation**

Based on a voluntary independent investigation by a Special Committee of the Board of Directors in 2006 of our past practices related to granting stock options, we determined that the price on the actual measurement date for a number of our stock option grants from 1997 through 2005 and into 2006 did not correspond to the price on the stated grant date and that certain option grants were retroactively priced. The investigation was conducted with the help of a law firm that was not previously involved with our stock option plans and procedures. The Special Committee completed the investigation on November 16, 2006. Based upon the Special Committee's recommendations, the Board of Directors took specific actions. The SEC commenced an informal inquiry upon notification by us of the initiation of our investigation. We provided the results of our internal review and independent investigation to the SEC, and we have responded to requests from the SEC for documents and

additional information. In March 2007, the SEC issued a formal order directing a private investigation. We are fully cooperating with the SEC.

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We are 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 over contractual relationships 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 the above matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of any such matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows. In addition to the litigation discussed above, the following lawsuits related to the outcome of our stock option investigation have been filed:

*Civil Action No. 07-456 (Consolidated); Bacas and Halgren, derivatively on behalf of HCC Insurance Holdings, Inc. v. Way et al.; In the United States District Court for the Southern District of Texas, Houston Division.* This action consolidated all pending derivative suits into one action (*Bacas* suits). The *Bacas* action was filed on February 1, 2007, and the *Halgren* action was filed on February 28, 2007. On February 1, 2008, the parties appeared before the Court to seek approval of a proposed settlement in the case. Under the terms of the settlement, we have or will implement certain corporate governance reforms, and we and our directors and officers liability insurers agreed to pay up to \$3.0 million to plaintiffs counsel for their attorneys fees. On April 1, 2008, the Court held a final hearing, granted final approval of the settlement, which includes no admission of liability or wrongdoing by HCC or any other defendants, and dismissed the case with prejudice. The plaintiffs attorneys fees were paid as agreed by HCC and its insurers.

*Civil Action No. 07-0801; In re HCC Insurance Holdings, Inc. Securities Litigation; In the United States District Court for the Southern District of Texas, Houston Division (formerly referred to as Bristol County Retirement System, individually and on behalf of all others similarly situated v. HCC Insurance Holdings, Inc. et al.).* This action was filed on March 8, 2007. We are named as a defendant in this putative class action along with certain current and former officers and directors. On February 7, 2008, the parties reached an agreement to settle the case and will propose the settlement to the Court for approval. The terms of the settlement, which includes no admission of liability or wrongdoing by HCC or any other defendants, provide for a full and complete release of all claims in the litigation and payment of \$10.0 million to be paid into a settlement fund, pending approval by the Court of a plan of distribution. The \$10.0 million will be paid by our directors and officers liability insurers. At a hearing on April 17, 2008, the Court gave preliminary approval of the proposed settlement. The hearing for final approval is scheduled for July 17, 2008.

**Indemnifications**

In conjunction with the sales of certain 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. Other indemnifications 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 indemnification expires on December 31, 2009.

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We accrue a loss related to our indemnifications when a valid claim is made by a buyer and we believe we have potential exposure. We currently have several claims under indemnifications that cover certain net losses alleged to have been incurred in periods prior to our sale of certain subsidiaries or otherwise alleged to be covered under indemnification agreements related to such sales. As of March 31, 2008, we have recorded a liability of \$15.6 million and have provided \$5.2 million of letters of credit to cover our obligations or anticipated payments under these indemnifications.

Pursuant to our bylaws, Delaware Corporate law and certain contractual agreements, we are required to advance attorneys' fees and other expenses and indemnify our current and former directors and officers for liabilities arising from any action, suit or proceeding brought because the individual was acting as an officer or director of our company. Under certain limited circumstances, the individual may be required to reimburse us for any advances or indemnification payments made by us. In addition, we maintain directors' and officers' liability insurance, which may cover certain of these costs. We expense payments as advanced and recognize offsets if cash reimbursement is expected or received. It is not possible to determine the maximum potential impact on our future consolidated net earnings of any such indemnification costs, since our bylaws, Delaware law and our contractual agreements do not limit any such advances or indemnification payments.

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

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

**Overview**

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain, Bermuda, Belgium and Ireland transacting business in more than 100 countries. Our group consists of insurance companies, Lloyd's of London syndicates, underwriting agencies and reinsurance brokers. Our shares are traded on the New York Stock Exchange, and we had a market capitalization of \$2.6 billion at March 31, 2008. We earned \$81.1 million or \$0.70 per diluted share in the first quarter of 2008, compared to \$96.7 million or \$0.83 per diluted share in 2007. The decrease in earnings is directly related to \$30.2 million (\$19.6 million after tax) of investment-related income in 2007 that did not occur in 2008 due to lower income from alternative investments, the change in fair value of our investments in two insurance companies accounted for as trading securities, and a gain on the sale of a strategic investment in 2007. We grew shareholders' equity by 3% in the first quarter of 2008 to \$2.5 billion, principally from net earnings.

We underwrite a variety of specialty lines of business identified as diversified financial products; group life, accident and health; aviation; London market account; and other specialty lines of business. Products in each line are marketed by our insurance companies and agencies, through a network of independent agents and brokers, directly to customers or through third party administrators. The majority of our business is low limit or small premium business that has less intense price competition, as well as lower catastrophe and volatility risk.

Our major domestic insurance companies are rated AA (Very Strong) by Standard & Poor's Corporation, AA (Very Strong) by Fitch Ratings and A+ (Superior) by A.M. Best Company, Inc., and our international insurance companies are rated AA by Standard & Poor's Corporation.

We generate our revenue from five primary sources:

risk-bearing earned premium produced by our insurance company operations,

non-risk-bearing fee and commission income received by our underwriting agency and broker operations,

ceding commissions in excess of policy acquisition costs earned by our insurance company operations,

investment income earned by all of our operations, and

other operating income.

We produced \$567.4 million of revenue in the first quarter of 2008, a decrease of 5% compared to the first quarter of 2007. This decrease principally resulted from the investment-related items discussed above.

During the past several years, we substantially increased our shareholders' equity by retaining most of our earnings and issuing additional shares of common stock. With this additional equity, we increased the underwriting capacity of our insurance companies and made strategic acquisitions, adding new lines of business or expanding those with favorable underwriting characteristics.

Our 2007 and 2008 acquisitions are listed below. Net earnings and cash flows from each acquired business are included in our operations beginning on the effective date of each transaction.

Company	Segment	Effective date acquired
Promoregistration.com	Agency	March 2, 2007
Pioneer General Insurance Company	Insurance Company	November 1, 2007
MultiNational Underwriters, LLC	Agency	January 2, 2008



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The following section discusses our key operating results. Amounts in the following tables are in thousands, except for earnings per share, percentages, ratios and number of employees. Comparisons refer to first quarter 2008 compared to first quarter 2007, unless otherwise noted.

**Results of Operations**

Net earnings decreased 16% to \$81.1 million (\$0.70 per diluted share) in 2008 from \$96.7 million (\$0.83 per diluted share) in 2007. The decrease in earnings primarily related to the aggregate of the following items, which resulted in a \$30.2 million pretax (\$19.6 million after tax) reduction in our 2008 earnings compared to 2007:

Our alternative investments, the income or loss from which are included in net investment income, generated \$1.2 million of losses in 2008, compared to \$7.0 million of income in 2007.

Our trading portfolio, which in 2008 is composed of the investment in the stock of two insurance companies, had unrealized losses of \$9.0 million in 2008, compared to unrealized gains of \$2.2 million in 2007. These gains and losses are reported in other operating income (loss). We discontinued the active trading of securities in late 2006.

We sold a strategic investment in 2007 and realized a gain of \$10.8 million, which is reported in other operating income (loss). We did not sell any strategic investments in 2008.

The trading losses and reduced income from our alternative investments were a direct result of general market conditions in 2008.

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

	Three months ended March 31,	
	2008	2007
Net earned premium	87.0%	83.3%
Fee and commission income	5.5	5.4
Net investment income	8.4	8.3
Net realized investment gain (loss)		(0.1)
Other operating income (loss)	(0.9)	3.1
Total revenue	100.0	100.0
Loss and loss adjustment expense, net	51.6	50.3
Policy acquisition costs, net	16.3	14.9
Other operating expense	10.4	9.7
Interest expense	0.7	0.5
Earnings before income tax expense	21.0	24.6
Income tax expense	6.7	8.4
<b>Net earnings</b>	<b>14.3%</b>	<b>16.2%</b>

Total revenue decreased 5% to \$567.4 million in 2008 principally due to the investment-related activity described above, as well as a slight decrease in premium due to the softening insurance market.

Our gross written premium, net written premium and net earned premium are detailed below. Gross written premium decreased because we elected not to write certain business, which would have been unprofitable due to competitive pressure on pricing in these lines of business. Net written premium declined less than gross due to increased retentions. See the Insurance Company Segment section below for further discussion of the relationship and changes in premium revenue.



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	Three months ended March 31,	
	2008	2007
<b>Gross written premium</b>	\$ 582,999	\$ 599,101
<b>Net written premium</b>	493,647	496,965
<b>Net earned premium</b>	493,546	497,600

Fee and commission income was relatively flat in 2008. The table below shows the source of our fee and commission income.

	Three months ended March 31,	
	2008	2007
Agencies	\$ 22,284	\$ 23,356
Insurance companies	8,715	8,769
<b>Fee and commission income</b>	\$ 30,999	\$ 32,125

The sources of net investment income are detailed below.

	Three months ended March 31,	
	2008	2007
Fixed income securities	\$ 40,924	\$ 34,007
Short-term investments	8,592	9,673
Other investments, including alternative investments	(938)	7,520
Total investment income	48,578	51,200
Investment expense	(957)	(1,733)
<b>Net investment income</b>	\$ 47,621	\$ 49,467

Net investment income decreased 4% in 2008 due to lower income from our alternative investments, primarily fund-of-fund hedge fund investments, which were impacted by generally poor equity and debt market conditions. Investment income on our fixed income securities increased 20% due to higher fixed income investments, which increased 19% to \$3.9 billion at March 31, 2008 compared to \$3.3 billion at March 31, 2007. The growth in fixed income securities resulted primarily from cash flow from operations, the increase in net loss reserves particularly from our diversified financial products line of business, which generally has a longer time period between reporting and payment of claims, and our shift away from short-term investments as short-term interest rates declined in 2008. Average yields on our short-term investments decreased from 5.5% in 2007 to 4.8% in 2008, while our fixed income tax equivalent yield was 5.3% in both 2007 and 2008. We continue to invest most of our funds in fixed income securities, with a weighted average duration of 5.0 years at March 31, 2008.

At March 31, 2008, the net unrealized gain on our fixed income securities portfolio was \$26.2 million, compared to \$25.0 million at December 31, 2007. The change in the net unrealized gain or loss, net of the related income tax

effect, is recorded in other comprehensive income and fluctuates with changes in market interest rates. Our general policy has been to hold our fixed income securities, which are classified as available for sale, through periods of fluctuating interest rates and to not realize significant gains or losses from their sale. The net unrealized gain on our fixed income securities portfolio at April 30, 2008 was \$17.2 million.

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Information about our portfolio of fixed income securities is as follows:

	Three months ended March 31,	
	2008	2007
Average short-term yield *	4.8%	5.5%
Average fixed income yield *	4.4%	4.4%
Average fixed income tax equivalent yield *	5.3%	5.3%
Weighted average tax equivalent yield *	4.8%	5.6%
Weighted average maturity	6.9 years	6.9 years
Weighted average duration	5.0 years	4.7 years
Average rating on fixed income securities	AA+	AAA

\* Excluding realized and unrealized gains and losses.

At March 31, 2008, within our portfolio of fixed income securities, we held a portfolio of residential mortgage-backed securities (MBSs) and collateralized mortgage obligations (CMOs) with a fair value of \$775.0 million. Within our residential MBS/CMO portfolio, \$657.4 million of bonds were guaranteed by U.S. government agencies, while \$102.2 million, \$11.1 million and \$4.3 million of bonds were collateralized by prime, Alt A and subprime mortgages, respectively. The underlying mortgages on our \$15.4 million of subprime-related securities (i.e. those collateralized by Alt A and subprime mortgages) were issued in the following years: 2002 \$2.7 million; 2003 \$3.2 million; 2004 \$0.2 million; 2005 \$1.0 million; 2006 \$4.1 million and 2007 \$4.2 million. At March 31, 2008, the subprime-related securities had an unrealized loss of \$1.4 million, all were current as to principal and interest, and none had an other-than-temporary impairment. These subprime-related securities have an average rating of AAA and a weighted average life of approximately 3.2 years. Our subprime-related securities represented 2.0% of our asset-backed and mortgage-backed securities portfolio and 0.4% of our total fixed income securities portfolio. At March 31, 2008, we held a commercial MBS portfolio with a fair value of \$200.9 million, an average rating of AAA, and a weighted average life of approximately 5.0 years. We owned no collateralized debt obligations (CDOs) or collateralized loan obligations (CLOs).

Other operating income was a loss of \$4.9 million in 2008 compared to a gain of \$18.6 million in 2007. The 2008 loss resulted from reduction in the market value of our two trading securities. The 2007 gain was primarily due to the sale of a strategic investment. Period to period comparisons in this category may vary substantially, depending on acquisition of new investments, income or loss related to changes in the market values of certain investments, and gains or losses related to any disposition. The following table details the components of our other operating income (loss).

	Three months ended March 31,	
	2008	2007
Strategic investments	\$ 913	\$ 11,659
Trading securities	(9,028)	2,181
Financial instruments	1,336	1,187
Other	1,833	3,558
<b>Other operating income (loss)</b>	<b>\$ (4,946)</b>	<b>\$ 18,585</b>

Loss and loss adjustment expense decreased 2% consistent with the slight reduction in net earned premium, and policy acquisition costs increased 4% due to a shift in the mix of business in 2008. See the Insurance Company Segment section below for further discussion of the changes in loss and loss adjustment expense and policy acquisition costs.

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Other operating expense increased 3% in 2008. The increase primarily related to compensation and other operating expenses of subsidiaries acquired in the fourth quarter of 2007 and the first quarter of 2008, partially offset by a \$2.2 million reduction in expenses related to our 2006 stock option matter incurred in 2007. We had 1,757 employees at March 31, 2008 compared to 1,632 a year earlier, with the increase primarily due to acquisitions.

Our effective income tax rate was 31.8% for 2008, compared to 34.1% for 2007. The lower effective rate primarily relates to an increase in tax-exempt interest income as a percentage of our overall pretax income in 2008 and the tax gain on the sale of a strategic investment greater than the book gain in 2007.

At March 31, 2008, book value per share was \$21.88, up from \$21.21 at December 31, 2007. Total assets were \$8.2 billion and shareholders' equity was \$2.5 billion, compared to \$8.1 billion and \$2.4 billion, respectively, at December 31, 2007.

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

Net earnings of our insurance company segment are relatively flat between years. Even though there is pricing competition in certain of our markets, our margins remain at an acceptable level of profitability due to our underwriting discipline.

***Premium***

Gross written premium in 2008 is 3% below the 2007 level, due to the impact of competition and the resulting softening of rates in several of our markets. In certain lines of business, we have elected not to renew policies or write new business if, in matching competitors' lower rates, the business would be unprofitable for us. In addition, in some lines of business, we have written the same exposure as in 2007 but at lower rates. The overall percentage of retained premium, as measured by the percent of net written premium to gross written premium, increased to 85% in 2008 from 83% in 2007.

The following tables provide premium information by line of business.

	Gross written premium	Net written premium	NWP as % of GWP	Net earned premium
<b><u>Three months ended March 31, 2008</u></b>				
Diversified financial products	\$ 211,364	\$ 180,501	85%	\$ 192,177
Group life, accident and health	210,534	202,375	96	192,446
Aviation	44,828	32,346	72	34,993
London market account	40,936	29,028	71	27,090
Other specialty lines	75,343	49,403	66	46,846
Discontinued lines	(6)	(6)	nm	(6)
<b>Totals</b>	<b>\$ 582,999</b>	<b>\$ 493,647</b>	<b>85%</b>	<b>\$ 493,546</b>

**Three months ended March 31, 2007**

Diversified financial products	\$ 212,253	\$ 171,792	81%	\$ 192,514
Group life, accident and health	202,906	192,426	95	192,416
Aviation	51,663	39,603	77	39,344
London market account	68,135	45,132	66	33,896
Other specialty lines	64,495	48,321	75	39,738
Discontinued lines	(351)	(309)	nm	(308)

<b>Totals</b>	\$ 599,101	\$ 496,965	83%	\$ 497,600
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nm Not meaningful

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

**Diversified financial products** The growth in net written premium and the retention rate resulted from increased quota share retentions on our U.S. professional indemnity and employment practices liability businesses in 2008. Premium volume in our major products was stable, although pricing for these products is down slightly.

**Group life, accident and health** The increase in gross and net written premium is from our acquisition of MultiNational Underwriters in 2008, for which we use one of our Lloyd's syndicates as the issuing carrier. Profit margins in this line remain at acceptable levels despite competition, principally from the fully insured market.

**Aviation** Our aviation premium volume is down due to competition, where we choose not to write international business at lower, unprofitable rates or renew domestic business at lower rates. Margins on decreased premium volume are still acceptable. Retention decreased as a result of an increase in proportional and facultative reinsurance.

**London market account** Gross premium levels are lower in 2008 as we have discontinued writing our marine excess of loss book of business, which was predominantly written in the first quarter of each year, due to unacceptable competitive rates. In addition, we have written business in 2008 at lower, but still profitable, rates. The net impact of these changes was moderated by a reduced reinsurance spend. Rates have softened due to benign catastrophe activity in the past two years, which has resulted in low London market loss ratios.

**Other specialty lines** We experienced growth in our other specialty lines of business from expansion of our Lloyd's syndicate participation and increased writings of several products. Markets for these products are competitive and rates are down slightly. The decrease in average retention is due to the change in mix of business on this line.

### ***Losses and Loss Adjustment Expenses***

Our net redundant (adverse) development relating to prior year losses included in net incurred loss and loss adjustment expense was \$5.1 million in 2008 compared to \$(0.2) million in 2007. The redundant development in 2008 primarily resulted from the re-estimation of our net exposure for certain case basis reserves. Deficiencies and redundancies in reserves occur as we review our loss reserves with our actuaries, increasing or reducing loss reserves as a result of such reviews and as losses are finally settled or claims exposures change.

We write directors' and officers' (D&O) and errors and omissions (E&O) liability coverage for public and private companies and not-for-profit organizations. The majority of our D&O business is written on an excess of loss basis with high attachment points. The majority of our E&O business generally has limits of up to \$1 million. Our D&O and E&O insurance is on a claims made basis, with defense costs included in the limits. Our in-force D&O business provides coverage for certain financial institutions, some of which have potential exposure to shareholder lawsuits due to recent subprime and credit market related issues. Certain of these financial institutions purchased Side A only coverage, which pays for covered defense costs and settlements or judgments arising from claims brought against directors and officers if, for some reason, the company does not or cannot indemnify a director or officer for such costs. We continue to closely monitor our D&O and E&O exposure to subprime issues. At March 31, 2008, we had nine Side A only and 32 non-Side A only D&O and E&O subprime-related claims, of which only one D&O claim was primary with a policy limit of \$5 million. Based on our current knowledge, we believe the company has provided for the ultimate losses that will eventually be incurred on our D&O and E&O businesses relating to subprime issues. We have no material exposure to environmental or asbestos losses.

We believe we have provided for all material net incurred losses as of March 31, 2008.

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Our gross loss ratio was 59.9% in 2008 and 58.2% in 2007. The following table provides comparative net loss ratios by line of business.

	Three months ended March 31,			
	2008		2007	
	Net earned premium	Net loss ratio	Net earned premium	Net loss ratio
Diversified financial products	\$ 192,177	46.2%	\$ 192,514	45.5%
Group life, accident and health	192,446	74.5	192,416	75.5
Aviation	34,993	57.6	39,344	50.1
London market account	27,090	33.2	33,896	57.3
Other specialty lines	46,846	66.9	39,738	69.8
Discontinued lines	(6)	nm	(308)	nm
<b>Totals</b>	<b>\$ 493,546</b>	<b>59.4%</b>	<b>\$ 497,600</b>	<b>60.4%</b>
<b>Expense ratio</b>		<b>24.3</b>		<b>23.6</b>
<b>Combined ratio</b>		<b>83.7%</b>		<b>84.0%</b>

nm Not meaningful comparison

The changes in net loss ratios for our aviation and London market account lines of business were due to favorable and unfavorable adjustments in reserves, respectively, as a result of our settlement, in the first quarter of 2007, of litigation related to a reinsurer that became insolvent in 1999. These 2007 adjustments decreased the aviation loss ratio by 10.1 percentage points and increased the London market account loss ratio by 7.9 percentage points. These adjustments, together with other smaller adjustments related to this settlement that affected the group life, accident and health and discontinued lines, had a minimal impact on our consolidated incurred losses. Also, in 2008, the London market account line of business benefited from favorable development.

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

	Three months ended March 31,	
	2008	2007
Net reserves for loss and loss adjustment expense payable at beginning of period	\$ 2,342,800	\$ 2,108,961
Assumed book of business Lloyd's syndicate	29,053	
Incurred loss and loss adjustment expense	293,026	300,472
Loss and loss adjustment expense payments	(235,524)	(272,916)
<b>Net reserves for loss and loss adjustment expense payable at end of period</b>	<b>\$ 2,429,355</b>	<b>\$ 2,136,517</b>
<b>Net paid loss ratio</b>	<b>47.7%</b>	<b>54.8%</b>

The net paid loss ratio is the percentage of losses paid, net of reinsurance, divided by net earned premium for the period. The net paid loss ratio was higher in 2007 due to payment of claims in the London market account, some of which were related to the 2005 hurricanes.

**Table of Contents****Policy Acquisition Costs**

Policy acquisition costs, which are net of the related portion of commissions on reinsurance ceded, as a percentage of net earned premium increased to 18.7% in 2008 from 17.9% in 2007, principally due to a change in the mix of business. The GAAP expense ratio of 24.3% in 2008 increased in comparison to 23.6% in 2007 primarily for the same reason.

**Agency Segment**

Revenue from our agency segment increased to \$40.8 million in 2008 from \$39.0 million in 2007 primarily due to business from a company acquired in 2008. Segment net earnings were relatively flat, increasing in 2008 to \$5.1 million from \$4.9 million in 2007.

**Other Operations Segment**

Revenue and net earnings from our other operations segment decreased to a loss of \$6.2 million and \$5.1 million, respectively, in 2008 from revenue of \$18.3 million and net earnings of \$11.4 million in 2007 primarily due to lower income from strategic investments and the reduction in market value of our two trading securities. Results of this segment may vary substantially period to period depending on our investment in or disposition of strategic investments and activity in our remaining trading portfolio.

**Liquidity and Capital Resources**

We receive substantial cash from premiums, reinsurance recoverables, commutations, fee and commission income, proceeds from sales and redemptions of investments and investment income. Our principal cash outflows are for the payment of claims and loss adjustment expenses, premium payments to reinsurers, purchases of investments, debt service, policy acquisition costs, operating expenses, taxes and dividends.

Cash provided by operating activities can fluctuate due to timing differences in the collection of premiums and reinsurance recoverables and the payment of losses and premium and reinsurance balances payable and the completion of commutations. Our cash provided by operating activities has been strong in recent years due to:

our increasing net earnings,

growth in net written premium and net loss reserves due to organic growth, acquisitions and increased retentions,

commutations of selected reinsurance agreements, and

expansion of our diversified financial products line of business as a result of which we retain premium for a longer duration than had been the case prior to entering this business.

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

	Three months ended March	
	31,	
	2008	2007
Net earnings	\$ 81,101	\$ 96,690
Change in premium, claims and other receivables, net of reinsurance, other payables and restricted cash	(47,431)	(7,846)
Change in unearned premium, net	2,939	(732)
Change in loss and loss adjustment expense payable, net of reinsurance recoverables	94,516	127,712
Change in trading portfolio	9,062	10,958
Other, net	(4,387)	3,529
<b>Cash provided by operating activities</b>	<b>\$ 135,800</b>	<b>\$ 230,311</b>

Cash received from commutations, included in cash provided by operating activities, totaled \$7.5 million in 2008 and \$101.0 million in 2007. Excluding commutations, cash provided by operating activities remains significantly higher than net earnings due to increases in our net loss reserves.

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Our combined cash and investment portfolio increased by \$113.0 million during 2008 to a total of \$4.8 billion at March 31, 2008. We maintain a substantial level of cash and liquid short-term investments to meet anticipated payment obligations.

Our debt to total capital ratio was 12.6% at March 31, 2008 and 11.7% at December 31, 2007.

Our 1.30% Convertible Notes are subject to redemption anytime after April 1, 2009, or holders may require us to repurchase the Notes on April 1, 2009, 2014 or 2019 or if a change in control of HCC Insurance Holdings, Inc. occurs on or before April 1, 2009. We expect to use our Revolving Loan Facility to fund any Notes redeemed or repurchased. We believe that our operating cash flows, investments, Revolving Loan Facility, Standby Letter of Credit Facility, shelf registration and other sources of liquidity, as described in our Annual Report on Form 10-K for the year ended December 31, 2007, are sufficient to meet our operating needs for the foreseeable future.

**Fair Value Measurements**

Effective January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements*, for financial assets and financial liabilities measured at fair value on a recurring basis (at least annually). SFAS 157 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. Our adoption of SFAS 157 did not impact our 2008 or prior years consolidated financial position, results of operations or cash flows.

SFAS 157 applies to all financial instruments that are measured and reported at fair value. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 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. The degree of judgment used to measure fair value generally correlates to the type of pricing and other data used as inputs, or assumptions, in the valuation process. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our own market assumptions using the best information available to us. Based on the type of inputs used to measure the fair value of our financial instruments, we classify them into the following three-level hierarchy established by SFAS 157:

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 instruments are primarily U.S. Treasuries and equity securities listed on stock exchanges.

Our Level 2 instruments include most of our fixed income securities, which consist of U.S. government and agency securities, municipal bonds, certain corporate debt securities, and certain mortgage and asset-backed securities. Our Level 2 instruments also include our interest rate swap agreements, which were reflected as liabilities in our consolidated balance sheet at March 31, 2008. We obtain fair value measurements for the majority of our Level 2 instruments from an independent pricing service. The fair value measurements consider various 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. To validate the independent pricing service's fair values, we obtain the fair value for our fixed income securities from third party investment managers and compare the two sources of each security's fair value for reasonableness. In addition, we obtain an understanding of the methods used by the independent pricing service. When fair value measurements are not available from our independent pricing service, we use fair value measurements provided by third party investment managers, which are modeled using valuation methodologies and observable inputs similar to those listed above.

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Our Level 3 securities include certain fixed income securities, a short-term investment with extended repayment terms, and two insurance contracts that we account for as derivatives. We determine the fair value for Level 3 instruments based on internally developed models that use assumptions or other data that are not readily observable from objective sources. Because we use the lowest level significant input to determine our hierarchy classifications, a financial instrument may be classified in Level 3 even though there may be significant readily-observable inputs. We have excluded from our SFAS 157 disclosures certain assets, such as alternative investments and certain strategic investments in insurance-related companies, since we account for them using the equity method of accounting and have not elected to measure them at fair value, pursuant to the guidance of SFAS 159. These assets had a recorded value of approximately \$175.2 million at March 31, 2008.

The following table presents our assets and liabilities that are measured at fair value as of March 31, 2008.

	Level 1	Level 2	Level 3	Total
Fixed income securities	\$ 96,377	\$ 3,826,224	\$ 6,948	\$ 3,929,549
Short-term investments		113,646		113,646
Other investments	51,151		3,576	54,727
Other assets	19,856		18,136	37,992
<b>Total assets</b>	<b>\$ 167,384</b>	<b>\$ 3,939,870</b>	<b>\$ 28,660</b>	<b>\$ 4,135,914</b>
Accounts payable and accrued liabilities	\$	\$ 7,017	\$	\$ 7,017
<b>Total liabilities</b>	<b>\$</b>	<b>\$ 7,017</b>	<b>\$</b>	<b>\$ 7,017</b>

The following table presents the changes in fair value of our Level 3 category for the first quarter of 2008.

	Fixed income securities	Other investments	Other assets	Total
<b>Balance at January 1, 2008</b>	\$ 7,623	\$ 5,492	\$ 16,804	\$ 29,919
Net redemptions	(239)	(1,875)		(2,114)
Gains and (losses) unrealized	(436)	(41)	1,332	855
<b>Balance at March 31, 2008</b>	<b>\$ 6,948</b>	<b>\$ 3,576</b>	<b>\$ 18,136</b>	<b>\$ 28,660</b>

Unrealized gains and losses on our Level 3 fixed income securities and other investments are reported in other comprehensive income within shareholders' equity, and unrealized gains and losses on our Level 3 other assets are reported in other operating income.

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At March 31, 2008, our Level 3 financial instruments represented approximately 0.7% of our total assets that are measured at fair value. During the first quarter of 2008, we had no transfers in or out of our Level 3 category, but the total Level 3 asset balance was reduced due to our receipt of cash refunds from certain investments. We believe that our expected future cash receipts from our Level 3 financial instruments will equal or exceed their fair value at March 31, 2008.

We classified our residential MBS/CMO portfolio, of which 98% is either guaranteed by U.S. government agencies or collateralized by prime mortgages, as Level 2 assets because the fair value of the securities is derived from industry-standard models using observable market-based data. These securities have an average rating of AAA and a weighted average life of approximately 6.7 years. Although these securities are subject to fluctuations in fair value due to recent and potential future events in the credit and mortgage markets, we believe that we will not have any significant loss of principal related to these securities. If their fair value decreases in the future due to changes in our fair value inputs or assumptions, we believe our operating cash flows, other investments, Revolving Loan Facility, Standby Letter of Credit Facility, shelf registration and other sources of liquidity are sufficient to meet our operating needs for the foreseeable future.

**Recent Accounting Pronouncements**

The Financial Accounting Standards Board (FASB) has issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, to delay the effective date of SFAS No. 157, *Fair Value Measurements*, for nonfinancial assets and nonfinancial liabilities measured at fair value on a nonrecurring basis. For these items, FSP 157-2 will be effective January 1, 2009. We are evaluating what impact these future additional SFAS 157 requirements will have on our consolidated financial statements.

SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, issued by the FASB, became effective January 1, 2008. SFAS 159 allows a company to make an irrevocable election to measure eligible financial assets and financial liabilities at fair value that are not otherwise measured at fair value. Unrealized gains and losses for those items are reported in current earnings at each subsequent reporting date. As of January 1, 2008, we have not elected to value any additional assets or liabilities at fair value under the guidance of SFAS 159.

The FASB has issued SFAS No. 141 (revised 2007) (SFAS 141(R)), *Business Combinations*, and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, an amendment of Accounting Research Bulletin No. 51. SFAS 141(R) will change the accounting treatment for business combinations and will impact presentation of financial statements on the acquisition date and accounting for acquisitions in subsequent periods. SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of shareholders' equity. SFAS 141(R) and SFAS 160 will be effective January 1, 2009 and early adoption is not permitted. We are evaluating the impact SFAS 141(R) and SFAS 160 will have on our consolidated financial statements.

The FASB has issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB Statement No. 133, which expands the required disclosures about a company's derivative and hedging activities. SFAS 161 will be effective January 1, 2009. We are evaluating the impact SFAS 161 will have on the notes to our consolidated financial statements.

**Critical Accounting Policies**

We have made no changes in our methods of application of our critical accounting policies from the information provided in our Annual Report on Form 10-K for the year ended December 31, 2007.

**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, 2007.



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**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 March 31, 2008. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of March 31, 2008.

(b) Changes in Internal Control over Financial Reporting

During the first quarter of 2008, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Part II Other Information**

**Item 1. Legal Proceedings**

Based on a voluntary independent investigation by a Special Committee of the Board of Directors in 2006 of our past practices related to granting stock options, we determined that the price on the actual measurement date for a number of our stock option grants from 1997 through 2005 and into 2006 did not correspond to the price on the stated grant date and that certain option grants were retroactively priced. The investigation was conducted with the help of a law firm that was not previously involved with our stock option plans and procedures. The Special Committee completed the investigation on November 16, 2006. Based upon the Special Committee's recommendations, the Board of Directors took specific actions. The SEC commenced an informal inquiry upon notification by us of the initiation of our investigation. We provided the results of our internal review and independent investigation to the SEC, and we have responded to requests from the SEC for documents and additional information. In March 2007, the SEC issued a formal order directing a private investigation. We are fully cooperating with the SEC.

We are 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 over contractual relationships 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 the above 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 these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows. In addition to the litigation discussed above, the following lawsuits related to the outcome of our stock option investigation have been filed:

*Civil Action No. 07-456 (Consolidated); Bacas and Halgren, derivatively on behalf of HCC Insurance Holdings, Inc. v. Way et al.; In the United States District Court for the Southern District of Texas, Houston Division.* This action consolidated all pending derivative suits into one action (*Bacas* suits). The *Bacas* action was filed on February 1, 2007, and the *Halgren* action was filed on February 28, 2007. On February 1, 2008, the parties appeared before the Court to seek approval of a proposed settlement in the case. Under the terms of the settlement, we have or will implement certain corporate governance reforms, and we and our directors and

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officers liability insurers agreed to pay up to \$3.0 million to plaintiffs counsel for their attorneys fees. On April 1, 2008, the Court held a final hearing, granted final approval of the settlement, which includes no admission of liability or wrongdoing by HCC or any other defendants, and dismissed the case with prejudice. The plaintiffs attorneys fees were paid as agreed by HCC and its insurers.

*Civil Action No. 07-0801; In re HCC Insurance Holdings, Inc. Securities Litigation; In the United States District Court for the Southern District of Texas, Houston Division (formerly referred to as Bristol County Retirement System, individually and on behalf of all others similarly situated v. HCC Insurance Holdings, Inc. et al.).* This action was filed on March 8, 2007. We are named as a defendant in this putative class action along with certain current and former officers and directors. On February 7, 2008, the parties reached an agreement to settle the case and will propose the settlement to the Court for approval. The terms of the settlement, which includes no admission of liability or wrongdoing by HCC or any other defendants, provide for a full and complete release of all claims in the litigation and payment of \$10.0 million to be paid into a settlement fund, pending approval by the Court of a plan of distribution. The \$10.0 million will be paid by our directors and officers liability insurers. At a hearing on April 17, 2008, the Court gave preliminary approval of the proposed settlement. The hearing for final approval is scheduled for July 17, 2008.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors described in our Annual Report on Form 10-K for the year ended December 31, 2007.

**Item 6. Exhibits**

a. Exhibits

31.1 Certification by Chief Executive Officer

31.2 Certification by Chief Financial Officer

32.1 Certification with Respect to Quarterly Report

**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)

May 9, 2008

/s/ Frank J. Bramanti

(Date)

Frank J. Bramanti, Chief Executive Officer

May 9, 2008

/s/ Edward H. Ellis, Jr.

(Date)

Edward H. Ellis, Jr., Executive Vice President  
and Chief Financial Officer

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