

HCC INSURANCE HOLDINGS INC/DE/
Form 10-Q
August 03, 2012
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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, 2012.**

.. **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) | 76-0336636 (IRS Employer Identification No.) |
| 13403 Northwest Freeway, Houston, Texas (Address of principal executive offices) | 77040-6094 (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.

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Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.

On July 27, 2012, there were approximately 100.7 million shares of common stock outstanding.

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HCC Insurance Holdings, Inc. and Subsidiaries

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FORWARD-LOOKING STATEMENTS

This Report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. 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 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, if any, of climate change, on the risks we insure,

potential credit risk with brokers,

the effects of industry consolidations,

our assessment of underwriting risk,

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

the adequacy of reinsurance protection,

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

the occurrence of terrorist activities,

our ability to maintain our competitive position,

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,

attraction and retention of qualified employees,

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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 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, 2011.

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)**

| | June 30, | December 31, |
|--|----------------------|-----------------------|
| | 2012 | 2011 (as adjusted) |
| ASSETS | | |
| Investments | | |
| Fixed maturity securities available for sale, at fair value (amortized cost: 2012 \$5,712,890 and 2011 \$5,385,432) | \$ 6,097,866 | \$ 5,718,834 |
| Fixed maturity securities held to maturity, at amortized cost (fair value: \$163,136) | - | 161,102 |
| Equity securities available for sale, at fair value (cost: \$92,580) | 93,660 | - |
| Short-term investments, at cost (approximates fair value) | 217,087 | 133,917 |
| Other investments, at fair value (amortized cost: 2012 \$38,053 and 2011 \$38,230) | 37,720 | 35,897 |
| Total investments | 6,446,333 | 6,049,750 |
| Cash | 63,184 | 104,550 |
| Restricted cash | 202,642 | 229,821 |
| Premium, claims and other receivables | 679,569 | 688,732 |
| Reinsurance recoverables | 1,056,999 | 1,056,068 |
| Ceded unearned premium | 255,078 | 222,300 |
| Ceded life and annuity benefits | 59,803 | 61,061 |
| Deferred policy acquisition costs | 204,387 | 189,633 |
| Goodwill | 873,627 | 872,814 |
| Other assets | 167,519 | 122,549 |
| Total assets | \$ 10,009,141 | \$ 9,597,278 |
| LIABILITIES | | |
| Loss and loss adjustment expense payable | \$ 3,755,699 | \$ 3,658,317 |
| Life and annuity policy benefits | 59,803 | 61,061 |
| Reinsurance, premium and claims payable | 359,260 | 366,499 |
| Unearned premium | 1,147,121 | 1,031,034 |
| Deferred ceding commissions | 71,767 | 62,364 |
| Notes payable | 590,867 | 478,790 |
| Accounts payable and accrued liabilities | 681,367 | 665,231 |
| Total liabilities | 6,665,884 | 6,323,296 |
| SHAREHOLDERS EQUITY | | |
| Common stock, \$1.00 par value; 250,000 shares authorized (shares issued: 2012 123,449 and 2011 122,720; outstanding: 2012 100,737 and 2011 104,101) | 123,449 | 122,720 |

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| | | |
|---|----------------------|---------------------|
| Additional paid-in capital | 1,019,570 | 1,001,308 |
| Retained earnings | 2,574,411 | 2,429,818 |
| Accumulated other comprehensive income | 259,776 | 227,659 |
| Treasury stock, at cost (shares: 2012 22,712 and 2011 18,619) | (633,949) | (507,523) |
| Total shareholders equity | 3,343,257 | 3,273,982 |
| Total liabilities and shareholders equity | \$ 10,009,141 | \$ 9,597,278 |

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, | |
|---|---------------------------|-------------------|-----------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| REVENUE | | | | |
| Net earned premium | \$ 1,112,472 | \$ 1,032,731 | \$ 565,331 | \$ 524,251 |
| Net investment income | 110,300 | 104,017 | 53,290 | 52,422 |
| Other operating income | 12,389 | 14,796 | 7,188 | 7,475 |
| Net realized investment gain | 7,047 | 495 | 6,876 | 1,054 |
| Other-than-temporary impairment credit losses | (397) | (3,479) | (397) | (350) |
| Total revenue | 1,241,811 | 1,148,560 | 632,288 | 584,852 |
| EXPENSE | | | | |
| Loss and loss adjustment expense, net | 665,753 | 681,868 | 336,825 | 334,282 |
| Policy acquisition costs, net | 143,934 | 135,684 | 74,490 | 65,841 |
| Other operating expense | 167,706 | 160,237 | 80,424 | 82,390 |
| Interest expense | 13,139 | 10,987 | 6,230 | 5,434 |
| Total expense | 990,532 | 988,776 | 497,969 | 487,947 |
| Earnings before income tax expense | 251,279 | 159,784 | 134,319 | 96,905 |
| Income tax expense | 75,202 | 43,316 | 40,826 | 27,427 |
| Net earnings | \$ 176,077 | \$ 116,468 | \$ 93,493 | \$ 69,478 |
| Earnings per common share | | | | |
| Basic | \$ 1.71 | \$ 1.02 | \$ 0.92 | \$ 0.61 |
| Diluted | \$ 1.71 | \$ 1.02 | \$ 0.92 | \$ 0.61 |

See Notes to Consolidated Financial Statements.

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

| | Six months ended June 30, 2012 | June 30, 2011 | Three months ended June 30, 2012 | June 30, 2011 |
|---|-----------------------------------|-------------------|-------------------------------------|-------------------|
| Net earnings | \$ 176,077 | \$ 116,468 | \$ 93,493 | \$ 69,478 |
| Other comprehensive income: | | | | |
| Investment gains (losses): | | | | |
| Investment gains during the period | 61,313 | 55,378 | 39,673 | 77,835 |
| Income tax charge | 21,804 | 15,297 | 14,501 | 27,620 |
| Investment gains, net of tax | 39,509 | 40,081 | 25,172 | 50,215 |
| Less reclassification adjustments for: | | | | |
| Gains (losses) included in net earnings | 6,659 | (2,978) | 6,488 | 714 |
| Income tax charge (benefit) | 2,331 | (1,042) | 2,271 | 250 |
| Gains (losses) included in net earnings, net of tax | 4,328 | (1,936) | 4,217 | 464 |
| Net unrealized investment gains | 35,181 | 42,017 | 20,955 | 49,751 |
| Foreign currency translation adjustment | (3,313) | 8,162 | (5,846) | 2,137 |
| Income tax charge (benefit) | (249) | 1,478 | (372) | 1,478 |
| Foreign currency translation adjustment, net of tax | (3,064) | 6,684 | (5,474) | 659 |
| Other comprehensive income | 32,117 | 48,701 | 15,481 | 50,410 |
| Comprehensive income | \$ 208,194 | \$ 165,169 | \$ 108,974 | \$ 119,888 |

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, 2012

(unaudited, in thousands except per share data)

| | Common stock | Additional paid-in capital | Retained earnings | Accumulated other comprehensive income | Treasury stock | Total shareholders equity |
|---|-----------------|----------------------------------|----------------------|---|-------------------|---------------------------------|
| Balance at December 31, 2011 (as previously reported) | \$ 122,720 | \$ 1,001,308 | \$ 2,447,850 | \$ 227,659 | \$ (507,523) | \$ 3,292,014 |
| Cumulative effect of accounting change (deferred policy acquisition costs) | - | - | (18,032) | - | - | (18,032) |
| Balance at December 31, 2011 (as adjusted) | 122,720 | 1,001,308 | 2,429,818 | 227,659 | (507,523) | 3,273,982 |
| Net earnings | - | - | 176,077 | - | - | 176,077 |
| Other comprehensive income | - | - | - | 32,117 | - | 32,117 |
| Issuance of 516 shares for exercise of options, including tax effect | 516 | 13,128 | - | - | - | 13,644 |
| Purchase of 4,093 common shares | - | - | - | - | (126,426) | (126,426) |
| Stock-based compensation | 213 | 5,134 | - | - | - | 5,347 |
| Cash dividends declared, \$0.31 per share | - | - | (31,484) | - | - | (31,484) |
| Balance at June 30, 2012 | \$ 123,449 | \$ 1,019,570 | \$ 2,574,411 | \$ 259,776 | \$ (633,949) | \$ 3,343,257 |

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, | |
|---|----------------------------------|------------------|
| | 2012 | 2011 |
| Operating activities | | |
| Net earnings | \$ 176,077 | \$ 116,468 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Change in premium, claims and other receivables | (68,083) | (103,245) |
| Change in reinsurance recoverables | 2,921 | (84,728) |
| Change in ceded unearned premium | (32,951) | 36,870 |
| Change in loss and loss adjustment expense payable | 84,925 | 147,870 |
| Change in unearned premium | 116,448 | 63,015 |
| Change in reinsurance, premium and claims payable, excluding restricted cash | 3,290 | (30,413) |
| Change in accounts payable and accrued liabilities | (44,867) | (19,426) |
| Stock-based compensation expense | 6,168 | 7,137 |
| Depreciation and amortization expense | 9,133 | 8,769 |
| Other, net | (8,510) | (20,533) |
| Cash provided by operating activities | 244,551 | 121,784 |
| Investing activities | | |
| Sales of available for sale fixed maturity securities | 218,572 | 246,331 |
| Sales of equity securities | 1,739 | - |
| Maturity or call of available for sale fixed maturity securities | 325,046 | 285,637 |
| Maturity or call of held to maturity fixed maturity securities | 28,579 | 24,932 |
| Cost of available for sale fixed maturity securities acquired | (628,278) | (835,368) |
| Cost of equity securities acquired | (94,706) | - |
| Change in short-term investments | (62,621) | 292,365 |
| Cost of other investments acquired | - | (27,784) |
| Payments for purchase of businesses, net of cash received | (32,143) | (1,892) |
| Other, net | (6,982) | (10,942) |
| Cash used by investing activities | (250,794) | (26,721) |
| Financing activities | | |
| Advances on line of credit | 140,000 | 95,000 |
| Payments on line of credit | (28,000) | - |
| Sale of common stock | 13,644 | 35,236 |
| Purchase of common stock | (126,442) | (200,302) |
| Dividends paid | (32,002) | (33,305) |
| Other, net | (2,323) | (2,307) |
| Cash used by financing activities | (35,123) | (105,678) |
| Net decrease in cash | (41,366) | (10,615) |
| Cash at beginning of year | 104,550 | 97,857 |

| | | | | |
|------------------------------|----|--------|----|--------|
| Cash at end of period | \$ | 63,184 | \$ | 87,242 |
|------------------------------|----|--------|----|--------|

See Notes to Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

(1) General Information

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

Basis of Presentation

Our unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and include the accounts of HCC and its subsidiaries. We have made all adjustments that, in our opinion, are necessary for a fair statement of results of the interim periods, and all such adjustments are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2011. The consolidated balance sheet at December 31, 2011 was derived from the audited financial statements but does not include all disclosures required by GAAP.

Management must make estimates and assumptions that affect amounts reported in our consolidated financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. We have reclassified certain amounts in our 2011 consolidated financial statements to conform to the 2012 presentation. None of our reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

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.

During the second quarter of 2012, we entered into a forward contract to sell 45.0 million Euros for U.S. dollars in the third quarter of 2013. This transaction has been designated and qualifies as a hedge of our net investment in a Euro-functional currency subsidiary. Changes in the fair value of the forward contract, net of the related deferred tax effect, are recognized in our foreign currency translation adjustment, which is a component of accumulated other comprehensive income. This amount will 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 \$0.9 million liability at June 30, 2012. This amount is reported in accounts payable and accrued liabilities on our consolidated balance sheet. At inception of the hedge and quarterly thereafter, we assess whether the hedge transaction is effective. Any ineffectiveness would be recognized in earnings immediately as other operating expense. There was no ineffectiveness on the forward contract for the second quarter of 2012.

We enter into derivative transactions only with highly-rated financial institutions. At inception of the hedge and quarterly thereafter, we monitor counterparty exposures and any credit risk associated with the counterparty. We consider the risk of counterparty default to be minimal.

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, 2012, which is consistent with the timeframe for our annual assessment in prior years. For this assessment, we applied a new accounting standard that was effective for us in 2012. That guidance permits us to assess qualitative factors to determine whether it is more likely than not that the fair value of each of our reporting units is less than its carrying amount. Based on our

assessment, we determined that it was more likely than not that the fair value of each of our five reporting units exceeded its carrying amount as of June 30, 2012.

Table of Contents**HCC Insurance Holdings, Inc. and Subsidiaries****Notes to Consolidated Financial Statements****(unaudited, tables in thousands except per share data)****Accounting Guidance Adopted in 2012***Deferred Policy Acquisition Costs*

A new accounting standard clarifies the definition of acquisition costs incurred by an insurance company and limits capitalization to such costs directly related to renewing or acquiring new insurance contracts. Under the new standard, we expense all costs incurred for unsuccessful marketing or underwriting efforts, along with indirect costs, as incurred. We adopted this guidance on January 1, 2012 through retrospective adjustment of the capitalized deferred policy acquisition costs, deferred income taxes and consolidated shareholders' equity in our prior years consolidated financial statements. We also reclassified expenses in our prior years' consolidated income statements to reflect the new definition of policy acquisition costs. Application of the new guidance did not impact our reported consolidated net earnings or cash flows in prior years. The following line items in our consolidated financial statements were affected by this change in accounting guidance:

| | December 31, 2011 | | |
|--|---------------------------|-------------|-------------|
| | As originally reported | Change | As adjusted |
| Deferred policy acquisition costs | \$ 217,608 | \$ (27,975) | \$ 189,633 |
| Accounts payable and accrued liabilities (deferred income taxes) | 675,174 | (9,943) | 665,231 |
| Retained earnings | 2,447,850 | (18,032) | 2,429,818 |

| | Six months ended June 30, 2011 | | | Three months ended June 30, 2011 | | |
|-------------------------------|--------------------------------|-------------|-------------|----------------------------------|-------------|-------------|
| | As originally reported | Change | As adjusted | As originally reported | Change | As adjusted |
| Policy acquisition costs, net | \$ 167,861 | \$ (32,177) | \$ 135,684 | \$ 84,483 | \$ (18,642) | \$ 65,841 |
| Other operating expense | 128,060 | 32,177 | 160,237 | 63,748 | 18,642 | 82,390 |

Table of Contents**HCC Insurance Holdings, Inc. and Subsidiaries****Notes to Consolidated Financial Statements****(unaudited, tables in thousands except per share data)****(2) Investments**

On March 31, 2012, we reclassified our entire portfolio of fixed maturity securities classified as held to maturity, which consisted of corporate, U.S. government and foreign government securities, to fixed maturity securities classified as available for sale. Financial markets recently have been disrupted by several events, including the European debt crisis and the August 2011 downgrade of U.S. government debt by Standard & Poor's Corporation. Due to these market disruptions and our desire to maintain greater flexibility in managing our entire investment portfolio in an uncertain economy, we changed our prior intent to hold these securities to maturity. On the date of transfer, these securities had a fair value of \$139.1 million and an amortized cost of \$136.0 million. The securities' net unrealized appreciation, net of tax, increased our accumulated other comprehensive income and shareholders' equity by \$2.0 million as of March 31, 2012.

During the second quarter of 2012, we began investing in equity securities, which we classified as available for sale and report at fair value.

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

| | Cost or amortized cost | Gross unrealized gain | Gross unrealized loss | Fair value |
|--|------------------------------|-----------------------------|-----------------------------|---------------------|
| June 30, 2012 | | | | |
| Fixed maturity securities available for sale | | | | |
| U.S. government and government agency securities | \$ 220,995 | \$ 7,991 | \$ (15) | \$ 228,971 |
| Fixed maturity securities of states, municipalities and political subdivisions | 982,569 | 91,307 | (8) | 1,073,868 |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 1,858,848 | 148,858 | (158) | 2,007,548 |
| Corporate securities | 1,088,342 | 46,363 | (5,048) | 1,129,657 |
| Residential mortgage-backed securities | 854,262 | 50,485 | (1,915) | 902,832 |
| Commercial mortgage-backed securities | 382,595 | 34,109 | (4) | 416,700 |
| Asset-backed securities | 45,954 | 237 | (9) | 46,182 |
| Foreign government securities | 279,325 | 13,109 | (326) | 292,108 |
| Total fixed maturity securities available for sale | \$ 5,712,890 | \$ 392,459 | \$ (7,483) | \$ 6,097,866 |
| Equity securities available for sale | \$ 92,580 | \$ 2,957 | \$ (1,877) | \$ 93,660 |

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

(unaudited, tables in thousands except per share data)

| | Cost or amortized cost | Gross unrealized gain | Gross unrealized loss | Fair value |
|--|------------------------------|-----------------------------|-----------------------------|---------------------|
| December 31, 2011 | | | | |
| U.S. government and government agency securities | \$ 285,166 | \$ 10,523 | \$ (10) | \$ 295,679 |
| Fixed maturity securities of states, municipalities and political subdivisions | 999,940 | 85,528 | (127) | 1,085,341 |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 1,741,297 | 122,746 | (155) | 1,863,888 |
| Corporate securities | 817,886 | 35,221 | (6,774) | 846,333 |
| Residential mortgage-backed securities | 1,036,436 | 65,771 | (2,121) | 1,100,086 |
| Commercial mortgage-backed securities | 244,535 | 15,162 | (3,573) | 256,124 |
| Asset-backed securities | 34,655 | 147 | (56) | 34,746 |
| Foreign government securities | 225,517 | 11,203 | (83) | 236,637 |
| Total fixed maturity securities available for sale | \$ 5,385,432 | \$ 346,301 | \$ (12,899) | \$ 5,718,834 |
| U.S. government securities | \$ 6,998 | \$ 69 | \$ - | \$ 7,067 |
| Corporate securities | 110,284 | 1,814 | (455) | 111,643 |
| Foreign government securities | 43,820 | 746 | (140) | 44,426 |
| Total fixed maturity securities held to maturity | \$ 161,102 | \$ 2,629 | \$ (595) | \$ 163,136 |

Substantially all of our fixed maturity securities are investment grade and only one security was non-income producing in 2012. 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 Unrealized losses | | 12 months or more Unrealized losses | | Total Unrealized losses | |
|--|---|---------|---|---------|-------------------------------|---------|
| | Fair value | | Fair value | | Fair value | |
| June 30, 2012 | | | | | | |
| Fixed maturity securities | | | | | | |
| U.S. government and government agency securities | \$ 34,791 | \$ (15) | \$ - | \$ - | \$ 34,791 | \$ (15) |
| Fixed maturity securities of states, municipalities and political subdivisions | 2,177 | (8) | - | - | 2,177 | (8) |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 36,514 | (143) | 1,288 | (15) | 37,802 | (158) |
| Corporate securities | 235,506 | (5,048) | - | - | 235,506 | (5,048) |
| Residential mortgage-backed securities | 18,221 | (503) | 7,747 | (1,412) | 25,968 | (1,915) |
| Commercial mortgage-backed securities | 10,844 | (4) | - | - | 10,844 | (4) |
| Asset-backed securities | 10,263 | (9) | - | - | 10,263 | (9) |
| Foreign government securities | 43,739 | (326) | - | - | 43,739 | (326) |
| Equity securities | 32,880 | (1,877) | - | - | 32,880 | (1,877) |

| | | | | | | |
|--------------|------------|------------|----------|------------|------------|------------|
| Total | \$ 424,935 | \$ (7,933) | \$ 9,035 | \$ (1,427) | \$ 433,970 | \$ (9,360) |
|--------------|------------|------------|----------|------------|------------|------------|

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

(unaudited, tables in thousands except per share data)

| | Less than 12 months | | 12 months or more | | Total | |
|--|---------------------|--------------------|-------------------|-------------------|-------------------|--------------------|
| | Fair value | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses |
| December 31, 2011 | | | | | | |
| U.S. government and government agency securities | \$ 13,984 | \$ (10) | \$ - | \$ - | \$ 13,984 | \$ (10) |
| Fixed maturity securities of states, municipalities and political subdivisions | 10,256 | (107) | 899 | (20) | 11,155 | (127) |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 21,856 | (67) | 6,796 | (88) | 28,652 | (155) |
| Corporate securities | 154,856 | (6,391) | 18,005 | (383) | 172,861 | (6,774) |
| Residential mortgage-backed securities | 32,430 | (1,364) | 7,582 | (757) | 40,012 | (2,121) |
| Commercial mortgage-backed securities | 39,075 | (3,573) | - | - | 39,075 | (3,573) |
| Asset-backed securities | 19,648 | (56) | - | - | 19,648 | (56) |
| Foreign government securities | 4,198 | (83) | - | - | 4,198 | (83) |
| Total | \$ 296,303 | \$ (11,651) | \$ 33,282 | \$ (1,248) | \$ 329,585 | \$ (12,899) |

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. For other-than-temporary impairment losses, we recognize an other-than-temporary impairment loss in earnings in the period that we determine: 1) we intend to sell the security, 2) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis or 3) the security has a credit loss. Any non-credit portion of the other-than-temporary impairment loss is recognized in shareholders' equity.

Our other-than-temporary impairment losses were as follows:

| | Six months ended June 30, | | Three months ended June 30, | |
|--|---------------------------|-------------------|-----------------------------|-----------------|
| | 2012 | 2011 | 2012 | 2011 |
| Total other-than-temporary impairment loss | \$ (2,260) | \$ (4,677) | \$ (2,260) | \$ (1,548) |
| Portion recognized in other comprehensive income | 1,863 | 1,198 | 1,863 | 1,198 |
| Net other-than-temporary impairment loss recognized in earnings | \$ (397) | \$ (3,479) | \$ (397) | \$ (350) |

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

| | Six months ended June 30, | | Three months ended June 30, | |
|--------------------------------|---------------------------|----------|-----------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| Balance at beginning of period | \$ 5,047 | \$ 4,273 | \$ 5,047 | \$ 6,685 |

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| | | | | |
|--------------------------------------|----------|----------|----------|----------|
| Credit losses recognized in earnings | | | | |
| Securities previously impaired | 268 | 1,597 | 268 | 350 |
| Securities not previously impaired | 129 | 1,882 | 129 | - |
| Securities sold | - | (3,905) | - | (3,188) |
| Balance at June 30 | \$ 5,444 | \$ 3,847 | \$ 5,444 | \$ 3,847 |

We had \$1.2 million after-tax other-than-temporary impairment losses, related to mortgage-backed securities, included in accumulated other comprehensive income within shareholders' equity at June 30, 2012. This amount includes the after-tax unrealized gains and losses on these impaired securities resulting from changes in their fair value subsequent to their initial other-than-temporary impairment measurement dates.

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

We do not consider the \$9.4 million of gross unrealized losses on fixed maturity and equity securities in our portfolio at June 30, 2012 to be other-than-temporary impairments because: 1) as of June 30, 2012, we have received substantially all contractual interest and principal payments on the fixed maturity securities, 2) we do not intend to sell these 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 relates to non-credit factors, such as interest rate changes and market conditions.

The amortized cost and fair value of our fixed maturity securities at June 30, 2012, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The weighted-average life of our mortgage-backed and asset-backed securities was 4.4 years at June 30, 2012.

| | Cost or amortized cost | Fair value |
|---|-----------------------------------|---------------------|
| Due in 1 year or less | \$ 370,576 | \$ 374,881 |
| Due after 1 year through 5 years | 1,049,481 | 1,097,141 |
| Due after 5 years through 10 years | 1,244,147 | 1,352,001 |
| Due after 10 years through 15 years | 831,135 | 906,673 |
| Due after 15 years | 934,740 | 1,001,456 |
| Securities with contractual maturities | 4,430,079 | 4,732,152 |
| Mortgage-backed and asset-backed securities | 1,282,811 | 1,365,714 |
| Total fixed maturity securities | \$ 5,712,890 | \$ 6,097,866 |

The sources of net investment income were as follows:

| | Six months ended June 30, | | Three months ended June 30, | |
|---------------------------------|----------------------------------|-------------------|------------------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Fixed maturity securities | | | | |
| Taxable | \$ 58,218 | \$ 54,219 | \$ 27,103 | \$ 27,124 |
| Exempt from U.S. income taxes | 52,872 | 49,826 | 26,260 | 24,915 |
| Total fixed maturity securities | 111,090 | 104,045 | 53,363 | 52,039 |
| Equity securities | 993 | - | 993 | - |
| Short-term investments | 102 | 321 | 40 | 165 |
| Other investment income | 868 | 2,030 | 401 | 1,388 |
| Total investment income | 113,053 | 106,396 | 54,797 | 53,592 |
| Investment expense | (2,753) | (2,379) | (1,507) | (1,170) |
| Net investment income | \$ 110,300 | \$ 104,017 | \$ 53,290 | \$ 52,422 |

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

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

| | Six months ended June 30, | | Three months ended June 30, | |
|--|----------------------------------|---------------|------------------------------------|-----------------|
| | 2012 | 2011 | 2012 | 2011 |
| Gains | \$ 8,127 | \$ 4,319 | \$ 7,913 | \$ 4,099 |
| Losses | (1,080) | (3,824) | (1,037) | (3,045) |
| Net realized investment gain (loss) | \$ 7,047 | \$ 495 | \$ 6,876 | \$ 1,054 |

(3) 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, corporate debt securities, bank loans, and mortgage-backed and asset-backed securities. 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 we designate as a hedge of 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.

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

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 to value the remaining Level 2 investments. To validate that these quoted and modeled prices are reasonable estimates of fair value, we perform various quantitative and qualitative procedures, including: 1) evaluation of the underlying methodologies, 2) analysis of recent sales activity, 3) analytical review of our fair values against current market prices and 4) comparison of the pricing services' fair value to other pricing services' fair value for the same investment. No markets for our investments were judged to be inactive at period end. Based on these procedures, we did not adjust the prices or quotes provided by our independent pricing services or third party investment managers as of June 30, 2012 or December 31, 2011.

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

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 |
|--|-------------------|---------------------|-----------------|---------------------|
| June 30, 2012 | | | | |
| Fixed maturity securities available for sale | | | | |
| U.S. government and government agency securities | \$ 188,757 | \$ 40,214 | \$ - | \$ 228,971 |
| Fixed maturity securities of states, municipalities and political subdivisions | - | 1,073,868 | - | 1,073,868 |
| Special purpose revenue bonds of states, municipalities and political subdivisions | - | 2,007,548 | - | 2,007,548 |
| Corporate securities | - | 1,129,498 | 159 | 1,129,657 |
| Residential mortgage-backed securities | - | 902,832 | - | 902,832 |
| Commercial mortgage-backed securities | - | 416,700 | - | 416,700 |
| Asset-backed securities | - | 46,182 | - | 46,182 |
| Foreign government securities | - | 292,108 | - | 292,108 |
| Total fixed maturity securities available for sale | 188,757 | 5,908,950 | 159 | 6,097,866 |
| Equity securities available for sale | 93,660 | - | - | 93,660 |
| Short-term investments* | 129,828 | 87,259 | - | 217,087 |
| Other investments | 37,720 | - | - | 37,720 |
| Other assets | - | - | 1,847 | 1,847 |
| Total assets measured at fair value | \$ 449,965 | \$ 5,996,209 | \$ 2,006 | \$ 6,448,180 |
| Notes payable* | \$ - | \$ 635,479 | \$ - | \$ 635,479 |
| Accounts payable and accrued liabilities forward contract | - | 926 | - | 926 |

| | | | | | | | | |
|---|----|---|----|---------|----|---|----|---------|
| Total liabilities measured at fair value | \$ | - | \$ | 636,405 | \$ | - | \$ | 636,405 |
|---|----|---|----|---------|----|---|----|---------|

*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 |
|--|-------------------|---------------------|-----------------|---------------------|
| December 31, 2011 | | | | |
| Fixed maturity securities available for sale | | | | |
| U.S. government and government agency securities | \$ 201,582 | \$ 94,097 | \$ - | \$ 295,679 |
| Fixed maturity securities of states, municipalities and political subdivisions | - | 1,085,341 | - | 1,085,341 |
| Special purpose revenue bonds of states, municipalities and political subdivisions | - | 1,863,888 | - | 1,863,888 |
| Corporate securities | - | 846,178 | 155 | 846,333 |
| Residential mortgage-backed securities | - | 1,100,086 | - | 1,100,086 |
| Commercial mortgage-backed securities | - | 256,124 | - | 256,124 |
| Asset-backed securities | - | 33,731 | 1,015 | 34,746 |
| Foreign government securities | - | 236,637 | - | 236,637 |
| Total fixed maturity securities available for sale | 201,582 | 5,516,082 | 1,170 | 5,718,834 |
| Fixed maturity securities held to maturity* | - | 163,136 | - | 163,136 |
| Short-term investments* | 67,288 | 66,629 | - | 133,917 |
| Other investments | 35,720 | - | - | 35,720 |
| Other assets | - | - | 1,516 | 1,516 |
| Total assets measured at fair value | \$ 304,590 | \$ 5,745,847 | \$ 2,686 | \$ 6,053,123 |
| Notes payable* | \$ - | \$ 505,671 | \$ - | \$ 505,671 |

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

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

| | 2012 | | | 2011 | | |
|-------------------------------|-------------------------|--------------|----------|-------------------------|--------------|----------|
| | Fixed income securities | Other assets | Total | Fixed income securities | Other assets | Total |
| Balance at beginning of year | \$ 1,170 | \$ 1,516 | \$ 2,686 | \$ 1,438 | \$ 857 | \$ 2,295 |
| Net gains (losses) realized | - | - | - | (2) | - | (2) |
| Net gains (losses) unrealized | 2 | 215 | 217 | (11) | 263 | 252 |
| Sales | - | - | - | (144) | - | (144) |
| Transfers out of Level 3 | (1,015) | - | (1,015) | - | - | - |
| Balance at March 31 | 157 | 1,731 | 1,888 | 1,281 | 1,120 | 2,401 |
| Net gains (losses) realized | (1) | - | (1) | - | - | - |
| Net gains (losses) unrealized | 3 | 116 | 119 | 18 | 122 | 140 |

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| | | | | | | |
|---------------------------|--------|----------|----------|----------|----------|----------|
| Sales | - | - | - | (55) | - | (55) |
| Balance at June 30 | \$ 159 | \$ 1,847 | \$ 2,006 | \$ 1,244 | \$ 1,242 | \$ 2,486 |

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

We transferred an investment from Level 3 to Level 2 in the first quarter of 2012 because we were able to determine its fair value using inputs based on observable market data in the period transferred. There were no transfers between Level 1, Level 2 or Level 3 in the second quarter of 2012 or the first six months of 2011.

(4) 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 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, | |
|---|----------------------------------|---------------------|------------------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Direct written premium | \$ 1,222,766 | \$ 1,169,442 | \$ 677,996 | \$ 661,301 |
| Reinsurance assumed | 251,476 | 221,848 | 113,557 | 80,781 |
| Reinsurance ceded | (273,750) | (242,533) | (149,465) | (132,209) |
| Net written premium | \$ 1,200,492 | \$ 1,148,757 | \$ 642,088 | \$ 609,873 |
| Direct earned premium | \$ 1,193,537 | \$ 1,153,511 | \$ 602,354 | \$ 578,703 |
| Reinsurance assumed | 168,882 | 158,494 | 86,544 | 79,113 |
| Reinsurance ceded | (249,947) | (279,274) | (123,567) | (133,565) |
| Net earned premium | \$ 1,112,472 | \$ 1,032,731 | \$ 565,331 | \$ 524,251 |
| Direct loss and loss adjustment expense | \$ 727,921 | \$ 786,652 | \$ 362,529 | \$ 343,898 |
| Reinsurance assumed | 61,035 | 142,205 | 24,326 | 68,298 |
| Reinsurance ceded | (123,203) | (246,989) | (50,030) | (77,914) |
| Net loss and loss adjustment expense | \$ 665,753 | \$ 681,868 | \$ 336,825 | \$ 334,282 |
| Policy acquisition costs | \$ 198,156 | \$ 191,670 | \$ 102,421 | \$ 93,847 |
| Ceding commissions | (54,222) | (55,986) | (27,931) | (28,006) |
| Net policy acquisition costs | \$ 143,934 | \$ 135,684 | \$ 74,490 | \$ 65,841 |

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

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| | June 30, 2012 | December 31, 2011 |
|---|---------------------|----------------------|
| Reinsurance recoverable on paid losses | \$ 51,795 | \$ 83,109 |
| Reinsurance recoverable on outstanding losses | 518,288 | 477,760 |
| Reinsurance recoverable on incurred but not reported losses | 488,416 | 497,074 |
| Reserve for uncollectible reinsurance | (1,500) | (1,875) |
| Total reinsurance recoverables | \$ 1,056,999 | \$ 1,056,068 |

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

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, 2012 and December 31, 2011.

| | June 30, 2012 | December 31, 2011 |
|------------------------|--------------------------|------------------------------|
| Payables to reinsurers | \$ 229,525 | \$ 195,806 |
| Letters of credit | 104,097 | 120,589 |
| Cash | 105,586 | 83,731 |
| Total credits | \$ 439,208 | \$ 400,126 |

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

| | June 30, 2012 | December 31, 2011 |
|---|--------------------------|------------------------------|
| Loss and loss adjustment expense payable | \$ 3,755,699 | \$ 3,658,317 |
| Reinsurance recoverable on outstanding losses | (518,288) | (477,760) |
| Reinsurance recoverable on incurred but not reported losses | (488,416) | (497,074) |
| Net reserves | \$ 2,748,995 | \$ 2,683,483 |
| Unearned premium | \$ 1,147,121 | \$ 1,031,034 |
| Ceded unearned premium | (255,078) | (222,300) |
| Net unearned premium | \$ 892,043 | \$ 808,734 |
| Deferred policy acquisition costs | \$ 204,387 | \$ 189,633 |
| Deferred ceding commissions | (71,767) | (62,364) |
| Net deferred policy acquisition costs | \$ 132,620 | \$ 127,269 |

(5) Notes Payable

Notes payable were as follows:

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| | June 30, 2012 | December 31, 2011 |
|---|-------------------|----------------------|
| 6.30% Senior Notes | \$ 298,867 | \$ 298,790 |
| \$600.0 million Revolving Loan Facility | 292,000 | 180,000 |
| Total notes payable | \$ 590,867 | \$ 478,790 |

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

We have a \$90.0 million Standby Letter of Credit Facility that is used to guarantee our performance in our Lloyd's of London Syndicate 4141. There have been no changes to the terms and conditions related to our Senior Notes, the \$600.0 million Revolving Loan Facility (the Facility) or the Standby Letter of Credit 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, 2011.

The weighted-average interest rate on borrowings under the Facility at June 30, 2012 was 1.62%. The borrowings and letters of credit issued under the Facility reduced our available borrowing capacity on the Facility to \$298.1 million at June 30, 2012.

We were in compliance with debt covenants related to our Senior Notes, the Facility and the Standby Letter of Credit Facility at June 30, 2012.

(6) 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, | |
|---|----------------------------------|-------------------|------------------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earnings | \$ 176,077 | \$ 116,468 | \$ 93,493 | \$ 69,478 |
| Less: net earnings attributable to unvested restricted stock | (3,238) | (1,601) | (1,775) | (1,003) |
| Net earnings available to common stock | \$ 172,839 | \$ 114,867 | \$ 91,718 | \$ 68,475 |
| Weighted-average common shares outstanding | 100,802 | 112,569 | 99,563 | 111,389 |
| Dilutive effect of outstanding options (determined using treasury stock method) | 181 | 375 | 288 | 368 |
| Weighted-average common shares and potential common shares outstanding | 100,983 | 112,944 | 99,851 | 111,757 |
| Anti-dilutive stock options not included in treasury stock method computation | 1,990 | 917 | 642 | 424 |

(7) Stock-Based Compensation

In 2012, we granted the following shares of common stock, restricted stock awards, restricted stock units and stock options for the purchase of shares of our common stock. For all grants except stock options, we measure fair value based on the closing stock price of our common stock on the grant date. For stock options, we use the Black-Scholes single option pricing model to determine the fair value of an option on its grant date. The fair value of the common stock was expensed on the grant date. The fair value of the restricted stock awards, restricted stock units and stock options is being expensed over the vesting period.

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| | Number of shares | Weighted-average | | Vesting period |
|-------------------------|-----------------------------|----------------------------------|---------------------------------|---------------------------|
| | | grant date fair value | Aggregate fair value | |
| Common stock | 29 | \$ 31.49 | \$ 920 | None |
| Restricted stock awards | 218 | 30.69 | 6,689 | 2-4 years |
| Restricted stock units | 13 | 30.60 | 403 | 4 years |
| Stock options | 158 | 7.95 | 1,253 | 1-5 years |

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

We report HCC's results in six operating segments. Our insurance segments consist of the following:

U.S. Property & Casualty

Professional Liability

Accident & Health

U.S. Surety & Credit

International

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.

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.

The following tables present information by business segment.

| | U.S. Property & Casualty | Professional Liability | Accident & Health | U.S. Surety & Credit | International | Investing | Corporate & Other | Consolidated |
|---|-----------------------------|---------------------------|----------------------|-------------------------|---------------|-----------|----------------------|--------------|
| Six months ended June 30, 2012 | | | | | | | | |
| Net earned premium | \$ 177,852 | \$ 200,905 | \$ 436,397 | \$ 100,844 | \$ 196,472 | \$ - | \$ 2 | \$ 1,112,472 |
| Other revenue | 6,885 | 267 | 2,496 | 415 | 2,135 | 116,950 | 191 | 129,339 |
| Segment revenue | 184,737 | 201,172 | 438,893 | 101,259 | 198,607 | 116,950 | 193 | 1,241,811 |
| Loss and LAE | 100,927 | 134,323 | 324,717 | 26,723 | 79,623 | - | (560) | 665,753 |
| Other expense | 59,767 | 36,207 | 63,482 | 55,523 | 68,765 | - | 41,035 | 324,779 |
| Segment expense | 160,694 | 170,530 | 388,199 | 82,246 | 148,388 | - | 40,475 | 990,532 |

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| | | | | | | | | | | | | | | | | |
|---------------------------------------|----|--------|----|--------|----|--------|----|--------|----|--------|----|---------|----|----------|----|---------|
| Segment pretax earnings (loss) | \$ | 24,043 | \$ | 30,642 | \$ | 50,694 | \$ | 19,013 | \$ | 50,219 | \$ | 116,950 | \$ | (40,282) | \$ | 251,279 |
|---------------------------------------|----|--------|----|--------|----|--------|----|--------|----|--------|----|---------|----|----------|----|---------|

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 & Casualty | Professional Liability | Accident & Health | U.S. Surety & Credit | International | Investing | Corporate & Other | Consolidated |
|---|-----------------------------|---------------------------|----------------------|-------------------------|--------------------|-------------------|----------------------|-------------------|
| Six months ended June 30, 2011 | | | | | | | | |
| Net earned premium | \$ 159,175 | \$ 203,174 | \$ 400,657 | \$ 101,403 | \$ 168,164 | \$ - | \$ 158 | \$ 1,032,731 |
| Other revenue | 9,666 | 249 | 2,194 | 701 | 1,902 | 101,033 | 84 | 115,829 |
| Segment revenue | 168,841 | 203,423 | 402,851 | 102,104 | 170,066 | 101,033 | 242 | 1,148,560 |
| Loss and LAE | 92,428 | 138,015 | 291,605 | 29,687 | 130,393 | - | (260) | 681,868 |
| Other expense | 55,575 | 34,032 | 61,995 | 55,252 | 64,020 | - | 36,034 | 306,908 |
| Segment expense | 148,003 | 172,047 | 353,600 | 84,939 | 194,413 | - | 35,774 | 988,776 |
| Segment pretax earnings (loss) | \$ 20,838 | \$ 31,376 | \$ 49,251 | \$ 17,165 | \$ (24,347) | \$ 101,033 | \$ (35,532) | \$ 159,784 |
| Three months ended June 30, 2012 | | | | | | | | |
| Net earned premium | \$ 88,834 | \$ 99,467 | \$ 218,730 | \$ 53,115 | \$ 105,188 | \$ - | \$ (3) | \$ 565,331 |
| Other revenue | 4,522 | 134 | 1,158 | 200 | 941 | 59,769 | 233 | 66,957 |
| Segment revenue | 93,356 | 99,601 | 219,888 | 53,315 | 106,129 | 59,769 | 230 | 632,288 |
| Loss and LAE | 51,666 | 65,168 | 163,004 | 15,690 | 41,856 | - | (559) | 336,825 |
| Other expense | 30,045 | 18,676 | 32,164 | 27,403 | 36,612 | - | 16,244 | 161,144 |
| Segment expense | 81,711 | 83,844 | 195,168 | 43,093 | 78,468 | - | 15,685 | 497,969 |
| Segment pretax earnings (loss) | \$ 11,645 | \$ 15,757 | \$ 24,720 | \$ 10,222 | \$ 27,661 | \$ 59,769 | \$ (15,455) | \$ 134,319 |
| Three months ended June 30, 2011 | | | | | | | | |
| Net earned premium | \$ 78,921 | \$ 102,424 | \$ 202,117 | \$ 50,039 | \$ 90,717 | \$ - | \$ 33 | \$ 524,251 |
| Other revenue | 4,787 | 48 | 1,178 | 455 | 894 | 53,126 | 113 | 60,601 |
| Segment revenue | 83,708 | 102,472 | 203,295 | 50,494 | 91,611 | 53,126 | 146 | 584,852 |
| Loss and LAE | 44,944 | 71,752 | 146,747 | 14,648 | 56,221 | - | (30) | 334,282 |
| Other expense | 27,169 | 16,928 | 31,577 | 26,997 | 32,355 | - | 18,639 | 153,665 |
| Segment expense | 72,113 | 88,680 | 178,324 | 41,645 | 88,576 | - | 18,609 | 487,947 |
| Segment pretax earnings (loss) | \$ 11,595 | \$ 13,792 | \$ 24,971 | \$ 8,849 | \$ 3,035 | \$ 53,126 | \$ (18,463) | \$ 96,905 |

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Catastrophe losses reduced the International segment's pretax earnings by \$8.3 million and \$72.3 million in the first six months of 2012 and 2011, respectively, and \$4.7 million and \$22.8 million in the second quarter of 2012 and 2011, respectively.

Table of Contents**HCC Insurance Holdings, Inc. and Subsidiaries****Notes to Consolidated Financial Statements****(unaudited, tables in thousands except per share data)****(9) Commitments and Contingencies****Catastrophe and Large Loss 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 catastrophe losses are unpredictable. We assess our exposures in areas most vulnerable to natural catastrophes and apply procedures to ascertain our probable maximum loss from a single event. We maintain reinsurance protection that we believe is sufficient to limit our exposure to a foreseeable event. Following a catastrophic loss, we often incur additional costs for reinstatement premium to continue our reinsurance coverage for future loss events. Our pretax catastrophe losses were \$14.8 million gross and \$12.3 million net (after reinsurance and reinstatement premium) in the first six months of 2012 and \$120.3 million gross and \$73.3 million net in the same period of 2011.

Litigation

We are a party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of any such matters will not, individually or in the aggregate, have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Indemnifications

In conjunction with the sales of business assets and subsidiaries, we have provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to our responsibilities to perform under the sales contracts. Under other indemnifications, we agree to reimburse the purchasers for taxes or ERISA-related amounts, if any, assessed after the sale date but related to pre-sale activities. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires in 2025. We accrue a loss when a valid claim is made by a purchaser and we believe we have potential exposure. At June 30, 2012, we have an accrued liability of \$11.2 million, as well as \$6.2 million in escrow and \$3.2 million of letters of credit, to cover our obligations or anticipated payments under these indemnifications.

(10) Supplemental Information

Supplemental cash flow information was as follows:

| | Six months ended June 30, | | Three months ended June 30, | |
|---|----------------------------------|-------------|------------------------------------|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| Income taxes paid | \$ 39,448 | \$ 57,607 | \$ 33,664 | \$ 38,501 |
| Interest paid | 12,000 | 12,152 | 10,929 | 9,866 |
| Proceeds from sales of available for sale fixed maturity securities | 218,572 | 246,331 | 153,469 | 197,399 |
| Proceeds from sales of equity securities | 1,739 | - | 1,739 | - |
| Dividends declared but not paid at end of period | 15,618 | 15,992 | | |

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

The following Management's Discussion and Analysis should be read in conjunction with the Consolidated Financial Statements and the related Notes as of June 30, 2012 and December 31, 2011.

Overview

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain and Ireland, transacting business in approximately 180 countries. Our shares trade on the New York Stock Exchange and closed at \$30.81 on July 27, 2012, resulting in market capitalization of \$3.1 billion.

We underwrite a variety of relatively non-correlated specialty insurance products, including property and casualty, accident and health, surety and credit product lines. We market our insurance products through a network of independent agents and brokers, managing general agents and directly to consumers. In addition, we assume insurance written by other insurance companies. We manage our businesses through five 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.

Our business philosophy is to maximize underwriting profit while managing risk. We concentrate our insurance writings in selected specialty lines of business in which we believe we can achieve meaningful underwriting profit. We also rely on our experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to limit or reduce risk. Our business plan is shaped by our underlying business philosophy. As a result, our primary objective is to maximize net earnings and grow book value per share, rather than to grow gross written premium or our market 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, 2012 were as follows:

We had consolidated shareholders' equity of \$3.3 billion, with a book value per share of \$33.19.

We generated year-to-date net earnings of \$176.1 million, or \$1.71 per diluted share. Our second quarter earnings were \$93.5 million, or \$0.92 per diluted share.

We produced total revenue of \$1.2 billion and \$632.3 million in the first six months and second quarter, respectively. In the first six months, 90% related to net earned premium and 9% related to net investment income.

In the first six months, we recognized \$12.3 million of net catastrophe losses—\$4.0 million in our U.S. Property & Casualty segment from storms in the United States and \$8.3 million in our International segment from other small catastrophes. The second quarter included net catastrophe losses of \$4.7 million.

Our year-to-date net loss ratio was 59.8% and our combined ratio was 85.0%.

Our debt to capital ratio was 15.0%.

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We purchased \$126.4 million, or 4.1 million shares, of our common stock at an average cost of \$30.88 per share in the first six months of 2012.

We declared dividends of \$0.31 per share and paid \$32.0 million of dividends in the first six months of 2012.

Comparisons in the following sections refer to the first six months of 2012 compared to the same period of 2011, unless otherwise noted. Certain 2011 amounts have been adjusted to reflect our adoption of a new accounting standard as of January 1, 2012. See Note 1, General Information Accounting Guidance Adopted in 2012 to the Consolidated Financial Statements for a description of this guidance and the impact of our retrospective adoption on prior year results. Amounts in tables are in thousands, except for earnings per share, percentages, ratios and number of employees.

Table of Contents**Results of Operations**

Our results and key metrics for the six months and quarter ended June 30, 2012 and 2011 were as follows:

| | Six months ended June 30, | | Three months ended June 30, | |
|-----------------------------------|---------------------------|------------|-----------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earnings | \$ 176,077 | \$ 116,468 | \$ 93,493 | \$ 69,478 |
| Earnings per diluted share | \$ 1.71 | \$ 1.02 | \$ 0.92 | \$ 0.61 |
| Net loss ratio | 59.8 % | 66.0 % | 59.6 % | 63.8 % |
| Expense ratio | 25.2 | 25.9 | 25.3 | 25.4 |
| Combined ratio | 85.0 % | 91.9 % | 84.9 % | 89.2 % |

In 2012, we recognized catastrophe losses from United States storms, primarily in our public risk line of business within our U.S. Property and Casualty segment and from other small catastrophes in our property treaty line of business within our International segment. In 2011, we recognized losses from catastrophic events in Japan, New Zealand, Australia, the United States and Denmark. We reinsure a portion of our exposure to catastrophic events, although we incur some additional cost for reinstatement premium to continue our reinsurance coverage for future loss events. The following table summarizes our catastrophe losses, as well as the impact on our net earnings and key metrics in 2012 and 2011:

| | Six months ended June 30, | | Three months ended June 30, | |
|---|---------------------------|------------|-----------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Gross losses | \$ 14,795 | \$ 120,259 | \$ 7,735 | \$ 15,059 |
| Net losses, after reinsurance and reinstatement premium | \$ 12,257 | \$ 73,328 | \$ 4,653 | \$ 21,863 |
| Impact of net catastrophe losses on: | | | | |
| Net earnings per diluted share | \$ (0.08) | \$ (0.42) | \$ (0.03) | \$ (0.13) |
| Net loss ratio (percentage points) | 1.1 % | 6.6 % | 0.9 % | 3.9 % |
| Combined ratio (percentage points) | 1.1 % | 6.9 % | 0.8 % | 4.1 % |

Revenue

Total revenue increased \$93.3 million in the first six months of 2012, compared to the same period in 2011, primarily due to higher net earned premium.

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, | |
|--------------------------|---------------------------|------------|-----------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| U.S. Property & Casualty | \$ 318,613 | \$ 265,511 | \$ 165,466 | \$ 135,961 |
| Professional Liability | 245,750 | 262,272 | 144,505 | 161,152 |
| Accident & Health | 434,264 | 397,823 | 218,141 | 201,523 |
| U.S. Surety & Credit | 110,702 | 113,953 | 56,209 | 60,182 |
| International | 364,911 | 351,581 | 207,235 | 183,233 |
| Exited Lines | 2 | 150 | (3) | 31 |

| | | | | |
|------------------------------------|--------------|--------------|------------|------------|
| Total gross written premium | \$ 1,474,242 | \$ 1,391,290 | \$ 791,553 | \$ 742,082 |
|------------------------------------|--------------|--------------|------------|------------|

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| | Six months ended June 30, | | Three months ended June 30, | |
|----------------------------------|---------------------------|---------------------|-----------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| U.S. Property & Casualty | \$ 197,894 | \$ 180,436 | \$ 105,566 | \$ 93,714 |
| Professional Liability | 171,137 | 190,648 | 100,224 | 116,857 |
| Accident & Health | 433,740 | 397,500 | 217,856 | 201,395 |
| U.S. Surety & Credit | 96,096 | 105,101 | 51,392 | 55,394 |
| International | 301,623 | 274,922 | 167,053 | 142,482 |
| Exited Lines | 2 | 150 | (3) | 31 |
| Total net written premium | \$ 1,200,492 | \$ 1,148,757 | \$ 642,088 | \$ 609,873 |
| U.S. Property & Casualty | \$ 177,852 | \$ 159,175 | \$ 88,834 | \$ 78,921 |
| Professional Liability | 200,905 | 203,174 | 99,467 | 102,424 |
| Accident & Health | 436,397 | 400,657 | 218,730 | 202,117 |
| U.S. Surety & Credit | 100,844 | 101,403 | 53,115 | 50,039 |
| International | 196,472 | 168,164 | 105,188 | 90,717 |
| Exited Lines | 2 | 158 | (3) | 33 |
| Total net earned premium | \$ 1,112,472 | \$ 1,032,731 | \$ 565,331 | \$ 524,251 |

Growth in premium occurred in the U.S. Property & Casualty segment from our new business lines added in 2011 and increased aviation, public risk, contingency, residual value and title reinsurance premium; the Accident & Health segment from higher writings of our medical stop-loss product; and the International segment from new business and pricing increases in our energy line of business. In 2011, we recorded \$11.6 million (\$12.7 million ceded, net of \$1.1 million assumed) of catastrophe-related reinstatement premium, which reduced the International segment's 2011 net written and net earned premium. See the Segment Operations section below for further discussion of the relationship and changes in premium revenue within each segment.

Net investment income, which is included in our Investing segment, increased 6% year-over-year primarily due to higher income from fixed maturity securities, generated from an increased amount of investments. Our fixed maturity portfolio increased 9% from \$5.6 billion at June 30, 2011 to \$6.1 billion at June 30, 2012. In addition, we invested \$92.6 million in an equities portfolio in the second quarter of 2012. The growth in investments resulted primarily from cash flow from operations and a \$192.7 million increase in the net unrealized gain on available for sale securities since June 30, 2011.

The following table details the components of our other operating income. The fee and commission income relates to third party agency and broker commissions.

| | Six months ended June 30, | | Three months ended June 30, | |
|-------------------------------|---------------------------|------------------|-----------------------------|-----------------|
| | 2012 | 2011 | 2012 | 2011 |
| Fee and commission income | \$ 10,542 | \$ 13,221 | \$ 6,139 | \$ 6,612 |
| Financial instruments | 330 | 385 | 115 | 122 |
| Other | 1,517 | 1,190 | 934 | 741 |
| Other operating income | \$ 12,389 | \$ 14,796 | \$ 7,188 | \$ 7,475 |

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

The tables below detail, by segment, our net loss and loss adjustment expense and our net loss ratios.

| | Six months ended June 30, | | Three months ended June 30, | |
|---|---------------------------|-------------------|-----------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| U.S. Property & Casualty | \$ 100,927 | \$ 92,428 | \$ 51,666 | \$ 44,944 |
| Professional Liability | 134,323 | 138,015 | 65,168 | 71,752 |
| Accident & Health | 324,717 | 291,605 | 163,004 | 146,747 |
| U.S. Surety & Credit | 26,723 | 29,687 | 15,690 | 14,648 |
| International | 79,623 | 130,393 | 41,856 | 56,221 |
| Exited Lines | (560) | (260) | (559) | (30) |
| Net loss and loss adjustment expense | \$ 665,753 | \$ 681,868 | \$ 336,825 | \$ 334,282 |

| | | | | |
|--------------------------|--------|--------|--------|--------|
| U.S. Property & Casualty | 56.7 % | 58.1 % | 58.2 % | 56.9 % |
| Professional Liability | 66.9 | 67.9 | 65.5 | 70.1 |
| Accident & Health | 74.4 | 72.8 | 74.5 | 72.6 |
| U.S. Surety & Credit | 26.5 | 29.3 | 29.5 | 29.3 |
| International | 40.5 | 77.5 | 39.8 | 62.0 |

| | | | | |
|------------------------------------|---------------|---------------|---------------|---------------|
| Consolidated net loss ratio | 59.8 % | 66.0 % | 59.6 % | 63.8 % |
|------------------------------------|---------------|---------------|---------------|---------------|

| | | | | |
|--|---------------|---------------|---------------|---------------|
| Consolidated accident year net loss ratio | 59.8 % | 63.9 % | 59.6 % | 61.2 % |
|--|---------------|---------------|---------------|---------------|

Loss development represents an increase or decrease in estimates of ultimate losses related to prior accident years. Deficiencies and redundancies in ultimate loss estimates occur as we review our loss exposure with our actuaries, increasing or reducing estimates of our ultimate losses as a result of such reviews and as losses are finally settled or claims exposures change. The excess of total recorded net reserves over the actuarial point estimate approximated 4.3% of our recorded net reserves at June 30, 2012, compared to 4.2% at December 31, 2011. We recognized no development in the first six months of 2012, compared to adverse development of \$22.3 million in the first six months of 2011 (of which \$13.3 million was recognized in the second quarter), primarily in our Professional Liability segment. Our consolidated accident year net loss ratio was lower in 2012, compared to 2011, primarily due to higher catastrophe losses in 2011. 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, | |
|---|---------------------------|---------------------|-----------------------------|---------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net reserves for loss and loss adjustment expense payable at beginning of period | \$ 2,683,483 | \$ 2,537,772 | \$ 2,699,717 | \$ 2,611,096 |
| Net reserve additions from acquired businesses | 14,705 | 645 | - | - |
| Foreign currency adjustment | (4,456) | 27,986 | (21,579) | 5,770 |
| Net loss and loss adjustment expense | 665,753 | 681,868 | 336,825 | 334,282 |
| Net loss and loss adjustment expense payments | (610,490) | (635,326) | (265,968) | (338,203) |
| Net reserves for loss and loss adjustment expense payable at end of period | \$ 2,748,995 | \$ 2,612,945 | \$ 2,748,995 | \$ 2,612,945 |

| | | | | |
|----------------------------|--------|--------|--------|--------|
| Net paid loss ratio | 54.9 % | 61.5 % | 47.0 % | 64.5 % |
|----------------------------|--------|--------|--------|--------|

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Our net paid loss ratio decreased in 2012 due to substantially lower claims payments in our Professional Liability segment and our energy line of business in the second quarter of 2012, compared to the same period in 2011. We paid \$27.5 million in the first quarter of 2012 and \$26.7 million in the second quarter of 2011 to commute large contracts included in our Exited Lines. These commutations had no material effect on net earnings but increased our net paid loss ratios by 2.5 percentage points for the first six months of 2012, and 2.6 percentage points and 5.1 percentage points for the first six months and second quarter of 2011, respectively. The amount of claims paid fluctuates period to period due to our mix of business and the timing of claims settlement and catastrophic events.

Policy Acquisition Costs

Our policy acquisition cost percentage was 12.9% and 13.1% for the first six months of 2012 and 2011, respectively, and 13.2% and 12.6% for the second quarter of 2012 and 2011, respectively. The lower year-to-date percentage primarily relates to a change in the mix of business. The 2011 policy acquisition cost percentage was increased 0.1 percentage points due to \$11.6 million of reinstatement premium (recorded as a reduction of net earned premium).

Other Operating Expense

For the first six months of 2012, 62% of our other operating expense related to compensation and benefits for our 1,866 employees. Other operating expense increased 5% year-over-year, primarily due to increased bonus expense related to higher net earnings in 2012. Other operating expense decreased 2% quarter-over-quarter, primarily due to higher foreign currency benefit in 2012. We recognized foreign currency benefit of \$1.4 million and \$4.2 million in the first six months and second quarter of 2012, respectively, directly related to the fluctuations in the British pound sterling. The foreign currency benefit was \$2.0 million and \$0.8 million in the first six months and second quarter of 2011, respectively. Other operating expense included stock-based compensation expense of \$6.4 million in 2012 and \$7.8 million in 2011. At June 30, 2012, there was approximately \$26.7 million of total unrecognized compensation expense related to unvested options and restricted stock awards and units that is expected to be recognized over a weighted-average period of 2.8 years.

Interest Expense

Interest expense on debt and short-term borrowings was \$13.1 million and \$11.0 million in the first six months of 2012 and 2011, respectively, and \$6.2 million and \$5.4 million in the second quarter of 2012 and 2011, respectively. Our interest expense increased in 2012 due to a higher amount of outstanding borrowings on our \$600.0 million Revolving Loan Facility, primarily to fund purchases of our common stock. Our interest expense for 2012 and 2011 included \$9.7 million for our Senior Notes.

Income Tax Expense

Our effective income tax rate was 29.9% for the first six months of 2012, compared to 27.1% for the same period of 2011. The higher effective rate in 2012 is due to the relationship of pretax income and tax-exempt investment income in the two periods. Our pretax income was substantially lower in the first six months of 2011 due to \$73.3 million of net catastrophe losses, whereas our tax-exempt investment income was essentially flat during the 2012 and 2011 six-month periods.

Table of Contents**Segment Operations**

Each of our insurance segments bears risk for insurance coverage written within its portfolio of insurance products. Each segment generates income from premium written by our underwriting agencies, through third party agents and brokers, or on a direct basis. The insurance segments also write facultative or individual account reinsurance, as well as treaty reinsurance business. In some cases, we purchase reinsurance to limit the segments' net losses from both individual policy losses and multiple policy losses from catastrophe 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 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, | |
|---------------------------------------|---------------------------|-------------------|-----------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earned premium | \$ 177,852 | \$ 159,175 | \$ 88,834 | \$ 78,921 |
| Other revenue | 6,885 | 9,666 | 4,522 | 4,787 |
| Segment revenue | 184,737 | 168,841 | 93,356 | 83,708 |
| Loss and loss adjustment expense, net | 100,927 | 92,428 | 51,666 | 44,944 |
| Other expense | 59,767 | 55,575 | 30,045 | 27,169 |
| Segment expense | 160,694 | 148,003 | 81,711 | 72,113 |
| Segment pretax earnings | \$ 24,043 | \$ 20,838 | \$ 11,645 | \$ 11,595 |
| Net loss ratio | 56.7 % | 58.1 % | 58.2 % | 56.9 % |
| Expense ratio | 32.4 | 32.9 | 32.2 | 32.5 |
| Combined ratio | 89.1 % | 91.0 % | 90.4 % | 89.4 % |
| Aviation | \$ 58,220 | \$ 54,600 | \$ 29,397 | \$ 27,318 |
| E&O | 31,979 | 38,357 | 15,602 | 18,800 |
| Public Risk | 31,792 | 23,179 | 16,574 | 11,927 |
| Other | 55,861 | 43,039 | 27,261 | 20,876 |
| Total net earned premium | \$ 177,852 | \$ 159,175 | \$ 88,834 | \$ 78,921 |
| Aviation | 55.8 % | 63.7 % | 64.5 % | 68.9 % |
| E&O | 60.8 | 57.3 | 60.6 | 55.0 |
| Public Risk | 77.8 | 66.9 | 63.9 | 60.5 |
| Other | 43.4 | 46.8 | 46.4 | 41.0 |

| | | | | |
|-----------------------------|--------|--------|--------|--------|
| Total net loss ratio | 56.7 % | 58.1 % | 58.2 % | 56.9 % |
|-----------------------------|--------|--------|--------|--------|

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| | Six months ended June 30, | | Three months ended June 30, | |
|------------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Aviation | \$ 82,870 | \$ 79,056 | \$ 45,780 | \$ 37,608 |
| E&O | 31,493 | 36,998 | 14,602 | 17,305 |
| Public Risk | 43,245 | 34,298 | 23,461 | 16,845 |
| Other | 161,005 | 115,159 | 81,623 | 64,203 |
| Total gross written premium | \$ 318,613 | \$ 265,511 | \$ 165,466 | \$ 135,961 |
| Aviation | \$ 63,405 | \$ 59,085 | \$ 35,898 | \$ 31,691 |
| E&O | 30,235 | 36,586 | 13,730 | 17,020 |
| Public Risk | 35,567 | 26,396 | 19,973 | 13,144 |
| Other | 68,687 | 58,369 | 35,965 | 31,859 |
| Total net written premium | \$ 197,894 | \$ 180,436 | \$ 105,566 | \$ 93,714 |

Our U.S. Property & Casualty segment pretax earnings increased 15% year-over-year due to higher net earned premium and a lower net loss ratio. Net earned premium was higher in 2012 due to \$6.0 million of additional premium from our new technical property, primary casualty and excess casualty underwriting teams, as well as increases in aviation, public risk, contingency, residual value and title reinsurance premium.

These increases more than offset lower premium in our E&O line of business. Our new underwriting teams wrote \$28.4 million of gross premium in the first six months of 2012, compared to \$4.5 million in the same period of 2011. Segment earnings were impacted by \$4.0 million of net catastrophe losses in the first quarter of 2012, primarily in our public risk line of business. The 2011 segment earnings and net loss ratio reflect the impact of \$2.5 million of adverse loss development, including \$1.0 million in the second quarter of 2011. The segment had no loss development in 2012.

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, | |
|---------------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earned premium | \$ 200,905 | \$ 203,174 | \$ 99,467 | \$ 102,424 |
| Other revenue | 267 | 249 | 134 | 48 |
| Segment revenue | 201,172 | 203,423 | 99,601 | 102,472 |
| Loss and loss adjustment expense, net | 134,323 | 138,015 | 65,168 | 71,752 |
| Other expense | 36,207 | 34,032 | 18,676 | 16,928 |
| Segment expense | 170,530 | 172,047 | 83,844 | 88,680 |
| Segment pretax earnings | \$ 30,642 | \$ 31,376 | \$ 15,757 | \$ 13,792 |
| Net loss ratio | 66.9 % | 67.9 % | 65.5 % | 70.1 % |
| Expense ratio | 18.0 | 16.7 | 18.8 | 16.5 |
| Combined ratio | 84.9 % | 84.6 % | 84.3 % | 86.6 % |
| U.S. D&O | \$ 170,667 | \$ 180,254 | \$ 84,413 | \$ 90,279 |
| International D&O | 30,238 | 22,920 | 15,054 | 12,145 |
| Total net earned premium | \$ 200,905 | \$ 203,174 | \$ 99,467 | \$ 102,424 |
| U.S. D&O | 69.7 % | 69.3 % | 68.3 % | 72.2 % |
| International D&O | 51.0 | 57.2 | 50.1 | 54.3 |
| Total net loss ratio | 66.9 % | 67.9 % | 65.5 % | 70.1 % |
| U.S. D&O | \$ 186,184 | \$ 200,661 | \$ 111,188 | \$ 123,470 |
| International D&O | 59,566 | 61,611 | 33,317 | 37,682 |
| Total gross written premium | \$ 245,750 | \$ 262,272 | \$ 144,505 | \$ 161,152 |
| U.S. D&O | \$ 136,826 | \$ 153,692 | \$ 81,121 | \$ 94,081 |
| International D&O | 34,311 | 36,956 | 19,103 | 22,776 |
| Total net written premium | \$ 171,137 | \$ 190,648 | \$ 100,224 | \$ 116,857 |

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Our Professional Liability segment pretax earnings decreased 2% year-to-date due to lower net earned premium in 2012 and increased 14% quarter-over-quarter due to adverse development in 2011. Premium was lower in 2012 primarily due to reunderwriting our diversified financial products (DFP) product, which is included in U.S. D&O. In addition, we obtained more reinsurance in 2012. In 2011, the segment had adverse loss development related to DFP of \$17.0 million (representing 6.0 percentage points of the net loss ratio) in the first six months, and \$10.8 million (11.9 percentage points) in the second quarter. The segment had no adverse loss development in 2012. We increased DFP's ultimate loss ratio on underwriting year 2011 in the third quarter of 2011 and continued to use that same ultimate loss ratio in 2012 for DFP's underwriting year 2011 premium that earned in 2012.

Table of Contents**Accident & Health Segment**

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

| | Six months ended June 30, | | Three months ended June 30, | |
|---------------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earned premium | \$ 436,397 | \$ 400,657 | \$ 218,730 | \$ 202,117 |
| Other revenue | 2,496 | 2,194 | 1,158 | 1,178 |
| Segment revenue | 438,893 | 402,851 | 219,888 | 203,295 |
| Loss and loss adjustment expense, net | 324,717 | 291,605 | 163,004 | 146,747 |
| Other expense | 63,482 | 61,995 | 32,164 | 31,577 |
| Segment expense | 388,199 | 353,600 | 195,168 | 178,324 |
| Segment pretax earnings | \$ 50,694 | \$ 49,251 | \$ 24,720 | \$ 24,971 |
| Net loss ratio | 74.4 % | 72.8 % | 74.5 % | 72.6 % |
| Expense ratio | 14.5 | 15.4 | 14.6 | 15.5 |
| Combined ratio | 88.9 % | 88.2 % | 89.1 % | 88.1 % |
| Medical Stop-loss | \$ 387,673 | \$ 351,056 | \$ 194,586 | \$ 176,147 |
| Other | 48,724 | 49,601 | 24,144 | 25,970 |
| Total net earned premium | \$ 436,397 | \$ 400,657 | \$ 218,730 | \$ 202,117 |
| Medical Stop-loss | 75.5 % | 74.0 % | 75.7 % | 74.1 % |
| Other | 65.9 | 64.2 | 65.3 | 62.2 |
| Total net loss ratio | 74.4 % | 72.8 % | 74.5 % | 72.6 % |
| Medical Stop-loss | \$ 387,974 | \$ 351,154 | \$ 194,741 | \$ 176,197 |
| Other | 46,290 | 46,669 | 23,400 | 25,326 |
| Total gross written premium | \$ 434,264 | \$ 397,823 | \$ 218,141 | \$ 201,523 |
| Medical Stop-loss | \$ 387,673 | \$ 351,056 | \$ 194,586 | \$ 176,147 |
| Other | 46,067 | 46,444 | 23,270 | 25,248 |
| Total net written premium | \$ 433,740 | \$ 397,500 | \$ 217,856 | \$ 201,395 |

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The Accident & Health segment pretax earnings increased 3% in the first six months of 2012, compared to 2011. 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, which were in line with medical loss cost trends, on renewal business.

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

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

| | Six months ended June 30, | | Three months ended June 30, | |
|---------------------------------------|---------------------------|-------------------|-----------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earned premium | \$ 100,844 | \$ 101,403 | \$ 53,115 | \$ 50,039 |
| Other revenue | 415 | 701 | 200 | 455 |
| Segment revenue | 101,259 | 102,104 | 53,315 | 50,494 |
| Loss and loss adjustment expense, net | 26,723 | 29,687 | 15,690 | 14,648 |
| Other expense | 55,523 | 55,252 | 27,403 | 26,997 |
| Segment expense | 82,246 | 84,939 | 43,093 | 41,645 |
| Segment pretax earnings | \$ 19,013 | \$ 17,165 | \$ 10,222 | \$ 8,849 |
| Net loss ratio | 26.5 % | 29.3 % | 29.5 % | 29.3 % |
| Expense ratio | 54.8 | 54.1 | 51.4 | 53.5 |
| Combined ratio | 81.3 % | 83.4 % | 80.9 % | 82.8 % |
| Surety | \$ 79,608 | \$ 80,809 | \$ 39,688 | \$ 40,148 |
| Credit | 21,236 | 20,594 | 13,427 | 9,891 |
| Total net earned premium | \$ 100,844 | \$ 101,403 | \$ 53,115 | \$ 50,039 |
| Surety | 24.8 % | 25.3 % | 24.8 % | 25.2 % |
| Credit | 33.0 | 44.9 | 43.7 | 45.8 |
| Total net loss ratio | 26.5 % | 29.3 % | 29.5 % | 29.3 % |
| Surety | \$ 80,762 | \$ 86,962 | \$ 40,836 | \$ 45,257 |
| Credit | 29,940 | 26,991 | 15,373 | 14,925 |
| Total gross written premium | \$ 110,702 | \$ 113,953 | \$ 56,209 | \$ 60,182 |
| Surety | \$ 73,385 | \$ 82,743 | \$ 37,251 | \$ 42,985 |
| Credit | 22,711 | 22,358 | 14,141 | 12,409 |
| Total net written premium | \$ 96,096 | \$ 105,101 | \$ 51,392 | \$ 55,394 |

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Our U.S. Surety & Credit segment pretax earnings increased 11% year-over-year and 16% quarter-over-quarter. Gross and net written premium in our surety line of business decreased in 2012 due to lower production of commercial bonds. New quota share reinsurance on certain products also reduced the 2012 net written premium. In the first quarter of 2012, we had a large loss in our credit line of business, which had significant reinsurance recoveries. Our losses net of these reinsurance recoveries were limited, resulting in a lower 2012 year-to-date loss ratio. The benefit related to the lower loss ratio was partially offset by a reduction of net written premium and net earned premium due to \$4.3 million of reinstatement premium related to this large loss.

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, | |
|---------------------------------------|---------------------------|--------------------|-----------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earned premium | \$ 196,472 | \$ 168,164 | \$ 105,188 | \$ 90,717 |
| Other revenue | 2,135 | 1,902 | 941 | 894 |
| Segment revenue | 198,607 | 170,066 | 106,129 | 91,611 |
| Loss and loss adjustment expense, net | 79,623 | 130,393 | 41,856 | 56,221 |
| Other expense | 68,765 | 64,020 | 36,612 | 32,355 |
| Segment expense | 148,388 | 194,413 | 78,468 | 88,576 |
| Segment pretax income (loss) | \$ 50,219 | \$ (24,347) | \$ 27,661 | \$ 3,035 |
| Net loss ratio | 40.5 % | 77.5 % | 39.8 % | 62.0 % |
| Expense ratio | 34.6 | 37.6 | 34.5 | 35.3 |
| Combined ratio | 75.1 % | 115.1 % | 74.3 % | 97.3 % |
| Energy | \$ 40,889 | \$ 28,683 | \$ 25,795 | \$ 16,634 |
| Property Treaty | 49,007 | 37,965 | 26,918 | 21,961 |
| Liability | 39,131 | 39,898 | 19,649 | 19,966 |
| Surety & Credit | 34,945 | 36,057 | 17,184 | 18,683 |
| Other | 32,500 | 25,561 | 15,642 | 13,473 |
| Total net earned premium | \$ 196,472 | \$ 168,164 | \$ 105,188 | \$ 90,717 |
| Energy | 41.6 % | 59.8 % | 44.2 % | 44.5 % |
| Property Treaty | 17.7 | 103.4 | 21.7 | 86.5 |
| Liability | 49.5 | 51.2 | 47.9 | 50.6 |
| Surety & Credit | 58.2 | 41.2 | 48.2 | 42.0 |
| Other | 43.7 | 151.3 | 44.2 | 88.2 |
| Total net loss ratios | 40.5 % | 77.5 % | 39.8 % | 62.0 % |
| Energy | \$ 110,714 | \$ 96,381 | \$ 90,119 | \$ 80,078 |
| Property Treaty | 113,855 | 104,115 | 44,517 | 32,296 |
| Liability | 40,242 | 48,071 | 20,982 | 23,953 |
| Surety & Credit | 43,451 | 47,189 | 22,493 | 20,516 |
| Other | 56,649 | 55,825 | 29,124 | 26,390 |

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| | | | | |
|------------------------------------|------------|------------|------------|------------|
| Total gross written premium | \$ 364,911 | \$ 351,581 | \$ 207,235 | \$ 183,233 |
|------------------------------------|------------|------------|------------|------------|

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| | Six months ended June 30, | | Three months ended June 30, | |
|----------------------------------|---------------------------|-------------------|-----------------------------|-------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Energy | \$ 81,013 | \$ 62,897 | \$ 68,189 | \$ 57,845 |
| Property Treaty | 99,819 | 86,126 | 37,517 | 24,966 |
| Liability | 37,316 | 44,433 | 19,424 | 22,073 |
| Surety & Credit | 39,813 | 43,466 | 20,786 | 18,708 |
| Other | 43,662 | 38,000 | 21,137 | 18,890 |
| Total net written premium | \$ 301,623 | \$ 274,922 | \$ 167,053 | \$ 142,482 |

Our International segment pretax earnings were impacted in both years by net catastrophe losses, which were substantially higher in 2011. The 2012 losses related to small catastrophes in our property treaty business. In 2011, we experienced losses from catastrophes in Japan, New Zealand, Australia, the United States and Denmark. The 2011 catastrophic events impacted our energy and property treaty lines of business, as well as our property (direct and facultative) and accident and health lines of business (both included in Other). We reinsured a portion of our exposure to these catastrophic events and incurred net reinstatement premium for continued reinsurance coverage, which reduced 2011 net written and net earned premium. The following table summarizes the segment's catastrophe losses, as well as the impact on key metrics:

| | Six months ended June 30, | | Three months ended June 30, | |
|---|---------------------------|------------------|-----------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Loss and loss adjustment expense, after reinsurance | \$ 8,668 | \$ 60,672 | \$ 5,835 | \$ 18,300 |
| Reinstatement premium, net | (411) | 11,608 | (1,182) | 4,515 |
| Total net catastrophe losses | \$ 8,257 | \$ 72,280 | \$ 4,653 | \$ 22,815 |

Impact of net catastrophe losses (percentage points):

| | | | | |
|-----------------------|--------------|---------------|--------------|---------------|
| Net loss ratio | 4.3 % | 38.7 % | 5.2 % | 22.2 % |
| Expense ratio | (0.1) | 2.4 | (0.4) | 1.6 |
| Combined ratio | 4.2 % | 41.1 % | 4.8 % | 23.8 % |

The segment's increase in net earned premium primarily related to higher writings in our energy product line, as well as the impact of reinstatement premium in our property treaty and property (direct and facultative) lines. The energy, property treaty and Other net loss ratios reflect the catastrophe losses. The higher expense ratios in 2011 were due to the impact of reinstatement premium on net earned premium.

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, 2012. Substantially all of our fixed maturity securities were investment grade and 77% were rated AAA or AA. At June 30, 2012, the portfolio's average tax equivalent yield was 4.8%, the weighted-average life was 7.8 years, and the weighted-average duration was 4.5 years.

The following tables summarize the investment results of our Investing segment.

| | Six months ended June 30, | | Three months ended June 30, | |
|---|---------------------------|-------------------|-----------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Fixed maturity securities | \$ 111,090 | \$ 104,045 | \$ 53,363 | \$ 52,039 |
| Equity securities | 993 | - | 993 | - |
| Short-term investments | 102 | 321 | 40 | 165 |
| Other investments | 868 | 2,030 | 401 | 1,388 |
| Net realized investment gain | 7,047 | 495 | 6,876 | 1,054 |
| Other-than-temporary impairment credit losses | (397) | (3,479) | (397) | (350) |
| Investment expenses | (2,753) | (2,379) | (1,507) | (1,170) |
| Segment pretax earnings | \$ 116,950 | \$ 101,033 | \$ 59,769 | \$ 53,126 |

| | | | | |
|--------------------------------|-----------|-----------|-------|-------|
| Fixed maturity securities: | | | | |
| Average yield * | 3.9 % | 3.9 % | 3.8 % | 3.9 % |
| Average tax equivalent yield * | 4.8 % | 4.8 % | 4.6 % | 4.7 % |
| Weighted-average life | 7.8 years | 7.2 years | | |
| Weighted-average duration | 4.5 years | 5.3 years | | |
| Weighted-average rating | AA | AA+ | | |

* Excluding realized and unrealized gains and losses.

In 2012, we began investing in bank loans (classified as Corporate securities), which we expect will generate attractive yields and lower our overall duration without altering the weighted-average duration of the portfolio. We also began investing in publicly-traded equity securities. As of June 30, 2012, we have invested \$98.7 million in bank loans and \$92.6 million in equity securities.

The weighted-average duration of our fixed maturity securities portfolio dropped between June 30, 2011 and June 30, 2012, primarily due to the impact of lower market interest rates on our municipal and structured securities with prepayment options. The decline in the weighted-average rating of our portfolio, which occurred in the third quarter of 2011, was a direct result of Standard & Poor's Corporation's downgrade of the U.S. government debt rating in August 2011.

On March 31, 2012, we reclassified our entire portfolio of fixed maturity securities classified as held to maturity, which consisted of corporate securities, U.S. government and foreign government securities, to fixed maturity securities classified as available for sale. Financial markets have been disrupted recently by several events, including the European debt crisis and the August 2011 downgrade of U.S. government debt by Standard & Poor's Corporation. Due to these market disruptions and our desire to maintain greater flexibility in managing our entire investment portfolio in an uncertain economy, we changed our prior intent to hold these securities to maturity. On the date of transfer, these securities had a fair value of \$139.1 million and an amortized cost of \$136.0 million. The transferred securities' net unrealized appreciation, net of tax, increased our accumulated other comprehensive income and shareholders' equity by \$2.0 million as of March 31, 2012.

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This table summarizes our investments by type, substantially all of which were reported at fair value, at June 30, 2012 and December 31, 2011.

| | June 30, 2012 | | December 31, 2011 | |
|--|---------------------|--------------|---------------------|--------------|
| | Amount | % | Amount | % |
| Fixed maturity securities | | | | |
| U.S. government and government agency securities | \$ 228,971 | 4 % | \$ 302,677 | 5 % |
| Fixed maturity securities of states, municipalities and political subdivisions | 1,073,868 | 17 | 1,085,341 | 18 |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 2,007,548 | 31 | 1,863,888 | 31 |
| Corporate securities | 1,129,657 | 17 | 956,617 | 16 |
| Residential mortgage-backed securities | 902,832 | 14 | 1,100,086 | 18 |
| Commercial mortgage-backed securities | 416,700 | 6 | 256,124 | 4 |
| Asset-backed securities | 46,182 | 1 | 34,746 | 1 |
| Foreign government securities | 292,108 | 5 | 280,457 | 4 |
| Equity securities | 93,660 | 1 | - | - |
| Short-term investments | 217,087 | 3 | 133,917 | 2 |
| Other investments | 37,720 | 1 | 35,897 | 1 |
| Total investments | \$ 6,446,333 | 100 % | \$ 6,049,750 | 100 % |

Our total investments increased \$396.6 million in 2012, principally from: 1) operating cash flow, 2) consolidation of our Lloyd's of London Syndicate 4040 upon its merger into Syndicate 4141 as of January 1, 2012 and 3) a \$54.7 million increase in the pretax net unrealized gain associated with our available for sale securities in the first six months of 2012. During 2011, we substantially reduced our short-term investments and re-invested the funds in long-term fixed maturity securities in order to maximize our investment return.

The ratings of our individual securities within our fixed maturity securities portfolio at June 30, 2012 were as follows:

| | Amount | % |
|--|---------------------|--------------|
| AAA | \$ 855,164 | 14 % |
| AA | 3,837,496 | 63 |
| A | 1,039,604 | 17 |
| BBB | 254,520 | 4 |
| BB and below | 111,082 | 2 |
| Total fixed maturity securities | \$ 6,097,866 | 100 % |

At June 30, 2012, we held \$2.0 billion of special purpose revenue bonds, as well as \$1.1 billion of general obligation bonds, which are issued by states, municipalities and political subdivisions and collectively referred to, in the investment market, as municipal bonds. The overall rating of our municipal bonds was AA at June 30, 2012. Within our municipal bond portfolio, we held \$366.8 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, 2012, the percentages of our special purpose revenue bond portfolio supported by these major revenue sources were as follows: 1) water and sewer 25%, 2) education 22%, 3) transportation 20%, 4) leasing 9% and 5) electric 7%.

Many of our special purpose revenue bonds are insured by mono-line insurance companies or supported by credit enhancement programs of various states and municipalities. We view bond insurance as credit enhancement and not credit substitution. We base our investment decision on the strength of the issuer. A credit review is performed on each issuer and on the sustainability of the revenue source before we acquire a special purpose revenue bond and periodically, on an ongoing basis, thereafter. The underlying average credit rating of our special purpose revenue bond issuers, excluding any bond insurance, was AA at June 30, 2012. Although recent economic conditions in the United States may

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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.

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At June 30, 2012, we held corporate fixed maturity securities issued by foreign corporations with an aggregate fair value of \$422.1 million. In addition, we held securities issued by foreign governments, agencies or supranational entities with an aggregate fair value of \$292.1 million. At June 30, 2012, our holdings of foreign debt were relatively unchanged from our holdings of foreign debt at December 31, 2011.

At June 30, 2012, we held a commercial mortgage-backed securities portfolio with a fair value of \$416.7 million, an average rating of AA+ and an average loan-to-value ratio of 71%. We owned no collateralized debt obligations (CDOs) or collateralized loan obligations (CLOs), and we are not a counterparty to any credit default swap transactions.

The methodologies used to determine the fair value of our investments are described in Note 3, *Fair Value Measurements* to the Consolidated Financial Statements. The accounting policies and procedures that we use to determine our other-than-temporary impairment losses are described in Note 2, *Investments* to the Consolidated Financial Statements and *Critical Accounting Policies - Other-than-temporary Impairments in Investments* in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2011.

Corporate & Other

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

| | Six months ended June 30, | | Three months ended June 30, | |
|---------------------------------------|---------------------------|--------------------|-----------------------------|--------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net earned premium | \$ 2 | \$ 158 | \$ (3) | \$ 33 |
| Other revenue | 191 | 84 | 233 | 113 |
| Total revenue | 193 | 242 | 230 | 146 |
| Loss and loss adjustment expense, net | (560) | (260) | (559) | (30) |
| Other expense - Exited Lines | 1,625 | 2,101 | 980 | 1,034 |
| Other expense - Corporate | 28,006 | 25,204 | 13,427 | 13,080 |
| Interest expense | 12,844 | 10,734 | 6,042 | 5,305 |
| Foreign currency benefit | (1,440) | (2,005) | (4,205) | (780) |
| Total expense | 40,475 | 35,774 | 15,685 | 18,609 |
| Pretax loss | \$ (40,282) | \$ (35,532) | \$ (15,455) | \$ (18,463) |

Our Corporate expenses not allocable to the segments increased \$2.8 million in 2012, primarily due to higher employee compensation and benefit costs and incremental expense related to our new technology systems. Our interest expense increased due to a higher amount of outstanding borrowings on our \$600.0 million Revolving Loan Facility in 2012.

The impact of foreign currency fluctuated period-over-period due to our increased level of available for sale securities denominated in foreign currencies and weakening of the British pound sterling relative to the U.S. dollar in 2012. We hold available for sale securities denominated in foreign currencies to economically hedge the currency exchange risk on our foreign-denominated loss reserves. The foreign currency gain or loss related to loss reserves is recorded through the income statement, while the foreign currency gain or loss related to available for sale securities is recorded through other comprehensive income within shareholders' equity. This mismatch may cause fluctuations in our reported foreign currency benefit or expense in future periods.

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Liquidity and Capital Resources

We believe we have sufficient sources of liquidity at a reasonable cost at the present time. Our primary sources of liquidity are as follows:

We held \$280.3 million of cash and liquid short-term investments at June 30, 2012.

Our available for sale securities portfolio had a fair value of \$6.2 billion at June 30, 2012, of which \$209.4 million was bonds and equity securities that are held directly by the parent company. We generally intend to hold fixed maturity securities until their maturity, but we would be able to sell securities to generate cash if the need arises.

We have a four-year \$600.0 million Revolving Loan Facility that expires on March 8, 2015. We had \$298.1 million of borrowing capacity available at June 30, 2012.

Our long-term debt consists of \$300.0 million principal amount of unsecured 6.30% Senior Notes due November 15, 2019. Our debt to total capital ratio was 15.0% at June 30, 2012 and 12.8% at December 31, 2011, with the increase related to our borrowings under the Revolving Loan Facility.

We have a \$90.0 million Standby Letter of Credit Facility that expires on December 31, 2015, which is used to guarantee our performance in our Lloyd's of London syndicate.

Our domestic insurance subsidiaries have the ability to pay \$255.1 million in dividends in 2012 to the parent company without obtaining special permission from state regulatory authorities. HCC can utilize these dividends for any purpose, including paying down debt, paying dividends to shareholders, funding acquisitions, purchasing our common stock and paying operating expenses.

We have a new Universal Shelf registration statement, which was filed and became effective in March 2012 and expires in March 2015. The current shelf registration statement provides for the issuance of an aggregate of \$1.0 billion of securities. These securities may be debt securities, equity securities, or a combination thereof. The shelf registration statement provides us the means to access the debt and equity markets relatively quickly, if we are satisfied with the current pricing in the financial market.

Capital Management

Notes Payable

There have been no changes to the terms and conditions related to our Senior Notes, the \$600.0 million Revolving Loan Facility (the Facility) or the Standby Letter of Credit Facility from those described in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources in our Annual Report on Form 10-K for the year ended December 31, 2011.

As of June 30, 2012, we had outstanding borrowings under the Facility of \$292.0 million, primarily to fund purchases of our common stock. The weighted-average interest rate on borrowings under the Facility at June 30, 2012 was 1.62%. The borrowings and letters of credit issued under the Facility reduced our available borrowing capacity on the Facility to \$298.1 million at June 30, 2012.

We were in compliance with debt covenants related to our Senior Notes, the Facility, and the Standby Letter of Credit Facility at June 30, 2012.

Table of ContentsShare Repurchases

On September 23, 2011, 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 opportunistically from time-to-time, 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 2012, we purchased \$59.5 million, or 1.9 million shares, at an average cost of \$31.17 per share. We purchased \$126.4 million, or 4.1 million shares, at an average cost of \$30.88 per share in the first six months of 2012. As of July 27, 2012, \$100.0 million of repurchase authority remains under the Plan.

Hedge of Investment in Subsidiary

During the second quarter of 2012, we entered into a forward contract to sell 45.0 million Euros for U.S. dollars in the third quarter of 2013. This transaction hedges our net investment in a Euro-functional currency subsidiary by limiting the negative impact of future decreases in the Euro relative to the U.S. dollar. Because this transaction qualifies as a hedge of our net investment in a Euro-functional currency subsidiary, changes in fair value of the forward contract will offset changes in the value of the net investment in subsidiary that is being hedged, with no impact on pretax earnings. The fair value of the forward contract was a \$0.9 million liability at June 30, 2012. See Note 1, General Information Derivative Financial Instrument to the Consolidated Financial Statements.

Cash Flow

We receive substantial cash from premiums, reinsurance recoverables, surety collateral, outward commutations, proceeds from sales and redemptions of investments, and investment income. Our principal cash outflows are for the payment of claims and loss adjustment expenses, premium payments to reinsurers, return of surety collateral, inward commutations, purchases of investments, debt service, policy acquisition costs, operating expenses, taxes, dividends, and common stock purchases. Cash provided by operating activities can fluctuate due to timing differences in the collection of premium receivables, reinsurance recoverables and surety collateral; the payment of losses, premium payables, return of surety collateral; and the completion of commutations.

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

| | Six months ended June 30, | |
|--|----------------------------------|-------------------|
| | 2012 | 2011 |
| Net earnings | \$ 176,077 | \$ 116,468 |
| Change in premium, claims and other receivables, net of reinsurance, premium and claims payables and excluding restricted cash | (64,793) | (133,658) |
| Change in unearned premium, net | 83,497 | 99,885 |
| Change in loss and loss adjustment expense payable, net of reinsurance recoverables | 87,846 | 63,142 |
| Other, net | (38,076) | (24,053) |
| Cash provided by operating activities | \$ 244,551 | \$ 121,784 |

We generated \$122.8 million more cash flow from operating activities in the first six months of 2012 than in the same period of 2011. The increase was primarily from additional premium collections, lower paid losses and the timing of tax payments. Our cash flow from operating activities was reduced \$27.5 million in 2012 and \$26.7 million in 2011 for payments we made to commute large contracts in our assumed accident and health reinsurance business reported in Exited Lines. Receipt and repayment of collateral funds related to surety bonds also decreased our cash flow from operating activities by \$21.2 million and \$18.4 million in 2012 and 2011, respectively.

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Accounting Guidance Adopted in 2012

See Note 1, General Information Accounting Guidance Adopted in 2012 to the Consolidated Financial Statements for a description of recently adopted accounting guidance related to deferred policy acquisition costs and its retrospective impact on our prior year consolidated financial statements.

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, 2011. We have made no changes in the identification or methods of application of these policies.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in market risk from the information provided in Item 7A, Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the year ended December 31, 2011, except as follows:

During the second quarter of 2012, we entered into a forward contract to sell 45.0 million Euros for U.S. dollars in the third quarter of 2013. The fair value of the forward contract was a \$0.9 million liability at June 30, 2012. A 10% increase (decrease) in the value of the Euro relative to the U.S. dollar would result in a \$5.7 million decrease (increase) in the fair value of the forward contract.

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, 2012. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of June 30, 2012.

(b) Changes in Internal Control over Financial Reporting

During the second quarter of 2012, we changed our third party provider for certain investment accounting and reporting functions in order to increase the overall efficiency of our financial reporting process. Other than this change, there were no changes in our internal control over financial reporting in the second quarter of 2012 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, 2011.

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

On September 23, 2011, 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 opportunistically, subject to market and business conditions, the level of cash generated from our operations, cash required for acquisitions, our debt covenant compliance, and other relevant factors. The Plan does not obligate us to purchase any particular number of shares, has no expiration date, and may be suspended or discontinued at any time at the Board's discretion. During the second quarter of 2012, we purchased our common stock, as follows:

| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Approximate dollar value of shares that may yet be purchased under the plans or programs |
|---------------|---|-------------------------------------|---|---|
| April | 983,987 | \$31.18 | 983,987 | \$128,779,510 |
| May | 723,802 | \$31.16 | 723,802 | \$106,228,203 |
| June | 200,677 | \$31.14 | 200,677 | \$99,979,638 |

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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Item 6. Exhibits

- 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 Second 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 May 25, 2012).
- 4.1 Indenture, dated August 23, 2001, between HCC Insurance Holdings, Inc. and First Union National Bank related to Debt Securities (incorporated by reference to Exhibit 4.1 to Current Report on Form 8-K filed on August 24, 2001).
- 4.2 Form of Fourth Supplemental Indenture, dated November 16, 2009, between HCC Insurance Holdings, Inc. and U.S. Bank National Association related to the 6.30% Senior Notes due 2019 (incorporated by reference to Exhibit 4.2 to Current Report on Form 8-K filed on November 13, 2009).
- 10.1 Amendment to Employment Agreement, dated May 15, 2012, between HCC Insurance Holdings, Inc. and John N. Molbeck, Jr. (incorporated by reference to Exhibit 10.1 to Current Report on Form 8-K filed on May 15, 2012).
- 10.2 Amendment to Employment Agreement, dated May 15, 2012, between HCC Insurance Holdings, Inc. and Christopher J. B. Williams (incorporated by reference to Exhibit 10.2 to Current Report on Form 8-K filed on May 15, 2012).
- 10.3 Form of Restricted Stock Award Agreement under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan (budget performance shares).
- 12 Statement of Ratios.
- 31.1 Certification by Chief Executive Officer.
- 31.2 Certification by Chief Financial Officer.
- 32.1 Certification with Respect to Quarterly Report.
- 101 The following financial statements from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 formatted in XBRL: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Earnings, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statement of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) Notes to Consolidated Financial Statements.*

Filed herewith.

- * The XBRL related information in Exhibit 101 shall not be deemed filed for the purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

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SIGNATURES

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

HCC Insurance Holdings, Inc.
(Registrant)

August 3, 2012
(Date)

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

August 3, 2012
(Date)

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