

HCC INSURANCE HOLDINGS INC/DE/

Form 10-K

February 29, 2008

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

- ▶ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**  
**○ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

**For the fiscal year ended December 31, 2007**

**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)*

**Securities registered pursuant to Section 12(b) of the Act:**

**Title of each class:**

**Name of each exchange on which registered:**

Common Stock, \$1.00 par Value

New York Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act: NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

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

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

The aggregate market value on June 30, 2007 (the last business day of the registrant's most recently completed second fiscal quarter) of the voting stock held by non-affiliates of the registrant was approximately \$3.7 billion. For purposes of the determination of the above-stated amount, only Directors and executive officers are presumed to be affiliates, but neither the registrant nor any such person concede that they are affiliates of the registrant.

The number of shares outstanding of the registrant's Common Stock, \$1.00 par value, at February 15, 2008 was 115.3 million.

#### **DOCUMENTS INCORPORATED BY REFERENCE:**

Information called for in Part III of this Form 10-K is incorporated by reference to the registrant's definitive Proxy Statement to be filed within 120 days of the close of the registrant's fiscal year in connection with the registrant's annual meeting of shareholders.

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**FORWARD-LOOKING STATEMENTS**

*This report on Form 10-K contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by*

*the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as growth of our business and operations, business strategy, competitive strengths, goals, plans, future capital expenditures and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, expect, intend, plan, probably or expressions, we are making forward-looking statements.*

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

*the effects of catastrophic losses;*

*the cyclical nature of the insurance business;*

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

*the effects of emerging claim and coverage issues;*

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

*potential credit risk with brokers;*

*our assessment of underwriting risk;*

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

*the adequacy of reinsurance protection;*

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

*the occurrence of terrorist activities;*

*our ability to maintain our competitive position;*

*changes in our assigned financial strength ratings;*

*our ability to raise capital in the future;*

*attraction and retention of qualified employees;*

*fluctuations in the fixed income securities market, which may reduce the value of our investment assets;*

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

*impairment of goodwill;*

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

*fluctuations in foreign exchange rates;*

*failures of our information technology systems;*

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

*change of control.*

*We describe these risks and uncertainties in greater detail in Item 1A, Risk Factors.*

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

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

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**PART I**

**Item 1. *Business***

**Business Overview**

HCC Insurance Holdings, Inc. is a Delaware corporation, which was formed in 1991. Its predecessor corporation was formed in 1974. Our principal executive offices are located at 13403 Northwest Freeway, Houston, Texas 77040, and our telephone number is (713) 690-7300. We maintain an Internet website at *www.hcc.com*. The reference to our Internet website address in this Report does not constitute the incorporation by reference of the information contained at the website in this Report. We will make available, free of charge through publication on our Internet website, a copy of our Annual Report on Form 10-K and quarterly reports on Form 10-Q and any current reports on Form 8-K or amendments to those reports, filed with or furnished to the Securities and Exchange Commission (SEC) as soon as reasonably practicable after we have filed or furnished such materials with the SEC.

As used in this report, unless otherwise required by the context, the terms *we*, *us* and *our* refer to HCC Insurance Holdings, Inc. and its consolidated subsidiaries and the term *HCC* refers only to HCC Insurance Holdings, Inc. All trade names or trademarks appearing in this report are the property of their respective holders.

We provide specialized property and casualty, surety, and group life, accident and health insurance coverages and related agency and reinsurance brokerage services to commercial customers and individuals. We concentrate our activities in selected, narrowly defined, specialty lines of business. We operate primarily in the United States, the United Kingdom, Spain, Bermuda, Belgium and Ireland. Some of our operations have a broader international scope. We underwrite on both a direct basis, where we insure a risk in exchange for a premium, and on a reinsurance (assumed) basis, where we insure all or a portion of another, or ceding, insurance company's risk in exchange for all or a portion of the ceding insurance company's premium for the risk. We market our products both directly to customers and through a network of independent and affiliated brokers, producers, agents and third party administrators.

Since our founding, we have been consistently profitable, generally reporting annual increases in total revenue and shareholders' equity. During the period 2003 through 2006, which is the latest period for which industry information is available, we had an average statutory combined ratio of 89.4% versus the less favorable 97.9% (source: A.M. Best Company, Inc.) recorded by the U.S. property and casualty insurance industry overall. During the period 2003 through 2007, our gross written premium increased from \$1.7 billion to \$2.5 billion, an increase of 41%, while net written premium increased 129% from \$0.9 billion to \$2.0 billion. During this period, our revenue increased from \$0.9 billion to \$2.4 billion, an increase of 154%. During the period December 31, 2003 through December 31, 2007, our shareholders' equity increased 133% from \$1.0 billion to \$2.4 billion and our assets increased 65% from \$4.9 billion to \$8.1 billion.

Our insurance companies are risk-bearing and focus their underwriting activities on providing insurance and/or reinsurance in the following lines of business:

Diversified financial products

Group life, accident and health

Aviation



London market account

Other specialty lines

Our domestic operating insurance companies are rated AA (Very Strong) (3rd of 23 ratings) by Standard & Poor's Corporation and AA (Very Strong) by Fitch Ratings (3rd of 21 ratings). Our international operating insurance companies are rated AA (Very Strong) by Standard & Poor's Corporation. Avemco Insurance Company, HCC Life Insurance Company, Houston Casualty Company and U.S. Specialty Insurance Company are rated A+ (Superior) (2nd of 16 ratings) by A.M. Best Company, Inc. American Contractors

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Indemnity Company, Perico Life Insurance Company, United States Surety Company and HCC Insurance Company are rated A (Excellent) (3rd of 16 ratings) by A.M. Best Company, Inc. Standard & Poor's, Fitch Ratings and A.M. Best are internationally recognized independent rating agencies. These financial strength ratings are intended to provide an independent opinion of an insurer's ability to meet its obligations to policyholders and are not evaluations directed at investors.

Our underwriting agencies underwrite on behalf of our insurance companies and in certain situations for other unaffiliated insurance companies. They receive fees for these services and do not bear any of the insurance risk of the companies for which they underwrite. Our underwriting agencies generate revenues based on fee income and profit commissions. The agencies specialize in the following types of business: contingency (including contest indemnification, event cancellation and weather coverages); directors' and officers' liability; individual disability (for athletes and other high profile individuals); kidnap and ransom; employment practices liability; marine; professional indemnity; public entity; various financial products; short-term medical; and other specialty business. Our principal underwriting agencies are Covenant Underwriters, G.B. Kenrick & Associates, HCC Global Financial Products, HCC Indemnity Guaranty Agency, HCC Specialty Underwriters, MultiNational Underwriters, LLC, Professional Indemnity Agency and RA&MCO Insurance Services.

Our brokers provide reinsurance and insurance brokerage services for our insurance companies, agencies and our clients and receive fees for their services. A reinsurance broker structures and arranges reinsurance between insurers seeking to cede insurance risks and reinsurers willing to assume such risks. Reinsurance brokers do not bear any of the insurance risks of their client companies. They earn commission income, and to a lesser extent, fees for certain services, generally paid by the insurance and reinsurance companies with whom the business is placed. Insurance broker operations consist of consulting with retail and wholesale clients by providing information about insurance coverage and marketing, placing and negotiating particular insurance risks. Our brokers specialize in placing insurance and reinsurance for group life, accident and health, aviation, surety, marine, and property and casualty lines of business. Our brokers are Continental Underwriters, HCC Risk Management and Rattner Mackenzie.

## **Our Strategy**

Our business philosophy is to maximize underwriting profits and produce non-risk-bearing fee and commission income while limiting risk in order to preserve shareholders' equity and maximize earnings. We concentrate our insurance writings in selected, narrowly defined, specialty lines of business in which we believe we can achieve an underwriting profit. We also rely on our experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to achieve our strategic objectives. We market our insurance products both directly to customers and through affiliated and independent brokers, agents, producers and third party administrators.

The property and casualty insurance industry and individual lines of business within the industry are cyclical. There are times when a large number of companies offer insurance on certain lines of business, causing premiums to trend downward. During other times, insurance companies limit their writings in certain lines of business due to lack of capital or following periods of excessive losses. This results in an increase in premiums for those companies that continue to write insurance in those lines of business.

In our insurance company operations, we believe our operational flexibility, which permits us to shift the focus of our insurance underwriting activity among our various lines of business, allows us to implement a strategy of emphasizing more profitable lines of business during periods of increased premium rates and de-emphasizing less profitable lines of business during periods of increased competition. In addition, we believe that our underwriting agencies and brokers complement our insurance underwriting activities. Our ability to utilize affiliated insurers, underwriting agencies and reinsurance brokers permits us to retain a greater portion of the gross revenue derived from our written premium.

Following a period in which premium rates rose substantially, premium rates in several of our lines of business became more competitive during the past four years. The rate decreases were more gradual than the prior rate increases; thus, our underwriting activities remain profitable. During the past several years, we expanded our underwriting activities and increased our retentions in response to these market conditions, to

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the increased spread provided by our overall book of business, and to our increased capital strength. During 2005 and 2006, we increased our retentions on certain of our lines of business that were not generally exposed to catastrophe risk and where profit margins were usually more predictable. These higher retention levels increased our net written and earned premium and have resulted in additional underwriting profits, investment income and net earnings.

Through reinsurance, our insurance companies transfer or cede all or part of the risk we have underwritten to a reinsurance company in exchange for all or part of the premium we receive in connection with the risk. We purchase reinsurance to limit the net loss to our insurance companies from both individual and catastrophic risks. The amount of reinsurance we purchase varies depending on, among other things, the particular risks inherent in the policies underwritten, the pricing of reinsurance and the competitive conditions within the relevant line of business.

When we decide to retain more underwriting risk in a particular line of business, we do so with the intention of retaining a greater portion of any underwriting profits without increasing our exposure to severe or catastrophe losses. In this regard, we may purchase less proportional or quota share reinsurance applicable to that line, thus accepting more of the risk but possibly replacing it with specific excess of loss reinsurance, in which we transfer to reinsurers both premium and losses on a non-proportional basis for individual and catastrophic risks above a retention point. Additionally, we may obtain facultative reinsurance protection on individual risks. In some cases, we may choose not to purchase reinsurance in a line of business in which we believe there has been a favorable loss history, our policy limits are relatively low or we determine there is a low likelihood of catastrophe exposure.

We also acquire or make strategic investments in companies that present an opportunity for future profits or for the enhancement of our business. We expect to continue to acquire complementary businesses. We believe that we can enhance acquired businesses through the synergies created by our underwriting capabilities and our other operations.

Our business plan is shaped by our underlying business philosophy, which is to maximize underwriting profit and net earnings while preserving and achieving long-term growth of shareholders' equity. As a result, our primary objective is to increase net earnings rather than market share or gross written premium.

In our ongoing operations, we will continue to:

- emphasize the underwriting of lines of business in which there is an anticipation of underwriting profits based on various factors including premium rates, the availability and cost of reinsurance, policy terms and conditions, and market conditions;

- limit our insurance companies' aggregate net loss exposure from a catastrophic loss through the use of reinsurance for those lines of business exposed to such losses and diversification into lines of business not exposed to such losses; and

- consider the potential acquisition of specialty insurance operations and other strategic investments.

## **Industry Segment and Geographic Information**

Financial information concerning our operations by industry segment and geographic data is included in the Consolidated Financial Statements and Notes thereto.

## **Acquisitions**

We have made a series of acquisitions that have furthered our overall business strategy. Our major transactions during the last three years are described below:

On February 25, 2005, we acquired United States Surety Company through a merger effected with its parent company, USSC Holdings, Inc. We issued 1.2 million shares of our common stock in connection with the acquisition. United States Surety Company is a Maryland-domiciled surety company and operates as a part of our HCC Surety Group.

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On July 14, 2005, we acquired the remaining 66% of De Montfort Group Limited that we did not already own for \$10.5 million and 274,000 shares of our common stock. We acquired our initial 34% interest in January 2005. The key operating subsidiary, De Montfort Insurance Company, provides surety and credit insurance. It was renamed HCC International Insurance Company, and a significant amount of our other United Kingdom operations were combined with this company.

On December 1, 2005, we acquired Perico Ltd., a medical stop-loss insurance underwriting agency headquartered in St. Louis, Missouri. We paid \$30.0 million and issued 158,599 shares of our common stock in connection with the acquisition. The operations of Perico Ltd. have been consolidated into Perico Life Insurance Company.

On December 13, 2005, we acquired MIC Life Insurance Corporation, a Delaware-domiciled insurance company, for \$20.0 million. MIC was renamed Perico Life Insurance Company and operates in St. Louis, Missouri.

On December 21, 2005, we acquired the remaining 80% of HCCL Holdings Limited (UK), formerly Illium Insurance Group, Ltd., that we did not already own for \$2.5 million. We acquired our initial 20% interest in March 2004. HCCL Holdings Limited (UK) is the parent of HCC Underwriting Agency Ltd. (UK), a managing agent for Syndicates 4040 and 4141 at Lloyd's of London, which specialize in United Kingdom third party liability, employers' liability and commercial motor risks and short-term medical risks, respectively. One of our insurance companies is a substantial participant in these syndicates.

On July 1, 2006, we acquired G.B. Kenrick & Associates, Inc., an underwriting agency located in Auburn Hills, Michigan, recognized as a premier underwriter of public entity insurance, for \$18.0 million cash. Kenrick operates as a subsidiary of Professional Indemnity Agency.

On October 2, 2006, we acquired the assets of the Health Products Division of Allianz Life Insurance Company of North America (the Health Products Division) for cash consideration of \$140.0 million and assumed the outstanding loss reserves. The Health Products Division's operations include medical stop-loss insurance for self-insured corporations and groups; medical excess insurance for HMOs; provider excess insurance for integrated delivery systems; excess medical reinsurance to small and regional insurance carriers; and LifeTrac, a network for providing organ and bone marrow transplants. During 2007, the Health Products Division wrote \$241.0 million in annual gross premium. We integrated the Health Products Division's operations into HCC Life Insurance Company.

On January 2, 2008, we acquired MultiNational Underwriters, LLC, an underwriting agency located in Indianapolis, Indiana for cash consideration of \$42.0 million and possible additional cash consideration depending upon future underwriting profit levels. This agency writes domestic and international short-term medical insurance. We formed Syndicate 4141 at Lloyd's of London to write the international business.

We continue to evaluate acquisition opportunities, and we may complete additional acquisitions during 2008. Any future acquisitions will be designed to expand and strengthen our existing lines of business or to provide access to additional specialty sectors, which we expect to contribute to our overall growth.

**Table of Contents****Insurance Company Operations***Lines of Business*

This table shows our insurance companies' total premium written, otherwise known as gross written premium, by line of business and the percentage of each line to total gross written premium (dollars in thousands):

|                                    | <b>2007</b>         |             | <b>2006</b>         |             | <b>2005</b>         |             |
|------------------------------------|---------------------|-------------|---------------------|-------------|---------------------|-------------|
| Diversified financial products     | \$ 963,355          | 39%         | \$ 956,057          | 43%         | \$ 908,526          | 45%         |
| Group life, accident and health    | 798,684             | 33          | 621,639             | 28          | 593,382             | 29          |
| Aviation                           | 195,809             | 8           | 216,208             | 10          | 210,530             | 10          |
| London market account              | 213,716             | 9           | 234,868             | 10          | 144,425             | 7           |
| Other specialty lines              | 280,040             | 11          | 205,651             | 9           | 176,139             | 9           |
| Discontinued lines of business     | (425)               |             | 1,225               |             | 5,284               |             |
| <b>Total gross written premium</b> | <b>\$ 2,451,179</b> | <b>100%</b> | <b>\$ 2,235,648</b> | <b>100%</b> | <b>\$ 2,038,286</b> | <b>100%</b> |

This table shows our insurance companies' actual premium retained, otherwise known as net written premium, by line of business and the percentage of each line to total net written premium (dollars in thousands):

|                                  | <b>2007</b>         |             | <b>2006</b>         |             | <b>2005</b>         |             |
|----------------------------------|---------------------|-------------|---------------------|-------------|---------------------|-------------|
| Diversified financial products   | \$ 771,648          | 39%         | \$ 794,232          | 44%         | \$ 675,942          | 45%         |
| Group life, accident and health  | 759,207             | 38          | 590,811             | 33          | 502,805             | 34          |
| Aviation                         | 145,761             | 7           | 166,258             | 9           | 130,743             | 9           |
| London market account            | 118,241             | 6           | 127,748             | 7           | 78,809              | 5           |
| Other specialty lines            | 191,151             | 10          | 133,481             | 7           | 109,106             | 7           |
| Discontinued lines of business   | (399)               |             | 22                  |             | 3,819               |             |
| <b>Total net written premium</b> | <b>\$ 1,985,609</b> | <b>100%</b> | <b>\$ 1,812,552</b> | <b>100%</b> | <b>\$ 1,501,224</b> | <b>100%</b> |

This table shows our insurance companies' net written premium as a percentage of gross written premium, otherwise referred to as percentage retained, for our continuing lines of business:

|                                 | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|---------------------------------|-------------|-------------|-------------|
| Diversified financial products  | 80%         | 83%         | 74%         |
| Group life, accident and health | 95          | 95          | 85          |
| Aviation                        | 74          | 77          | 62          |
| London market account           | 55          | 54          | 55          |
| Other specialty lines           | 68          | 65          | 62          |

|                                  |     |     |     |
|----------------------------------|-----|-----|-----|
| Consolidated percentage retained | 81% | 81% | 74% |
|----------------------------------|-----|-----|-----|

*Underwriting*

We underwrite business produced through affiliated underwriting agencies, through independent and affiliated brokers, producers and third party administrators, and by direct marketing efforts. We also write facultative or individual account reinsurance, as well as some treaty reinsurance business.



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***Diversified Financial Products***

We underwrite a variety of financial insurance risks in our diversified financial products line of business. These risks include:

|                                  |                            |
|----------------------------------|----------------------------|
| directors and officers liability | surety and credit          |
| employment practices liability   | various financial products |
| professional indemnity           |                            |

We began to underwrite this line of business through a predecessor company in 1977. Our insurance companies started participating in this business in 2001. We have substantially increased our level of business through the acquisition of a number of agencies and insurance companies that operate in this line of business, both domestically and internationally. Each of the acquired entities has significant experience in its respective specialty within this line of business. We have also formed entities developed around teams of experienced underwriters that offer these products.

In 2002 and 2003, following several years of insurance industry losses, significant rate increases were experienced throughout our diversified financial products line of business, particularly directors and officers liability, which we began underwriting in 2002. We benefited greatly from these improved conditions despite the fact that we had not been involved in the past losses. Rates softened between 2004 and 2007 for some of the products in this line, but our underwriting margins are still very profitable. There is also considerable investment income derived from diversified financial products due to the extended periods involved in claims resolution.

We had previously maintained reinsurance on our diversified financial products line of business, primarily on a proportional basis, but over the past three years we have substantially increased our retentions. Although individual losses in the directors and officers public company liability business may have potential severity, we expect this business to be profitable. Net premium written for the public company directors and officers liability was approximately \$202.0 million in 2007. The remainder of the diversified financial products business is less volatile with relatively low limits.

***Group Life, Accident and Health***

We write medical stop-loss business through HCC Life Insurance Company and, since its December 2005 acquisition, Perico Life Insurance Company. Our medical stop-loss insurance provides coverages to companies, associations and public entities that elect to self-insure their employees medical coverage for losses within specified levels, allowing them to manage the risk of excessive health insurance exposure by limiting aggregate and specific losses to a predetermined amount. We first began writing this business through a predecessor company in 1980. Our insurance companies started participating in this business in 1997. This line of business has grown both organically and through acquisitions. We are considered a market leader in medical stop-loss insurance. We also underwrite a small program of group life insurance, offered to our insureds as a complement to our medical stop-loss products.

Premium rates for medical stop-loss business rose substantially beginning in 2000 and, although competition has increased in recent years and the amount of premium rate increases has decreased, underwriting results have remained profitable. Premium rate increases together with deductible increases are still adequate to cover medical cost trends. Medical stop-loss business has relatively low limits, a low level of catastrophe exposure and a generally predictable result. Therefore, we have increased our retentions since 2001 and currently buy no reinsurance for this line of business.

Our risk management business is composed of provider excess, HMO and medical excess risks. This business has relatively lower limits and a low level of catastrophe exposure. The business is competitive, but remains profitable.

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We began writing alternative workers' compensation and occupational accident insurance in 1996. This business is currently written through U.S. Specialty Insurance Company. These products have relatively low limits, a relatively low level of catastrophe exposure and a generally predictable result.

With the acquisition of MultiNational Underwriters, LLC, we began writing short-term domestic and international medical insurance that covers individuals when there is a lapse in coverage or when traveling internationally. This business has relatively low limits and the term is generally of short duration. This business is primarily produced on an internet platform.

***Aviation***

We are a market leader in the general aviation insurance industry insuring aviation risks, both domestically and internationally. Types of aviation business we insure include:

|                                       |                                       |
|---------------------------------------|---------------------------------------|
| antique and vintage military aircraft | fixed base operations                 |
| cargo operators                       | military and law enforcement aircraft |
| commuter airlines                     | private aircraft owners               |
| corporate aircraft                    | rotor wing aircraft                   |

We offer coverages that include hulls, engines, avionics and other systems, liabilities, cargo and other ancillary coverages. We generally do not insure major airlines, major manufacturers, products or satellites. Insurance claims related to general aviation business tend to be seasonal, with the majority of the claims being incurred during warm weather months.

We have been underwriting aviation risks through Houston Casualty Company since 1981 and since 1959 in Avemco Insurance Company and U.S. Specialty Insurance Company, which were acquired in 1997. We are one of the largest writers of personal aircraft insurance in the United States. Our aviation gross premium has remained relatively stable since 1998, although we have increased our retentions as this business is predominantly written with small limits and has generally predictable results. The market related to international risks is very competitive and has seen rate decreases over the last few years, but is now showing signs of stabilizing.

***London Market Account***

Our London market account business consists of marine, energy, property, and accident and health business and has been primarily underwritten by Houston Casualty Company's London branch office. During 2006, we began to utilize HCC International Insurance Company to underwrite the non-U.S. based risks that comprise this line of business. This line includes most of our catastrophe exposures. We have underwritten these risks for more than 15 years, increasing or decreasing our premium volume depending on market conditions, which can be very volatile in this line. The following table presents the details of net premium written within the London market account line of business (in thousands):

|          | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|----------|-------------|-------------|-------------|
| Marine   | \$ 30,685   | \$ 26,664   | \$ 23,799   |
| Energy   | 45,962      | 57,619      | 15,621      |
| Property | 19,856      | 18,049      | 18,379      |

|  |                   |                   |                  |
|--|-------------------|-------------------|------------------|
| Accident and health                                    | 21,738            | 25,416            | 21,010           |
| <b>Total London market account net written premium</b> | <b>\$ 118,241</b> | <b>\$ 127,748</b> | <b>\$ 78,809</b> |

We underwrite marine risks for ocean-going vessels including hull, protection and indemnity, liabilities and cargo. We have underwritten marine risks since 1984 in varying amounts depending on market conditions.

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In our energy business, we underwrite physical damage, business interruption and other ancillary coverages. We have been underwriting both onshore and offshore energy risks since 1988. This business includes but is not limited to:

|  |                      |
|--|----------------------|
| drilling rigs                          | petrochemical plants |
| gas production and gathering platforms | pipelines            |
| natural gas facilities                 | refineries           |

Rates were relatively low for an extended period of time, reaching levels where underwriting profitability was difficult to achieve. As a result, we have underwritten energy risks on a very selective basis, striving for quality rather than quantity. Underwriting profitability was adversely impacted by hurricane activity that occurred in 2004 and 2005, but this resulted in 2006 rates increasing substantially and policy conditions becoming more stringent. Competitive pressures increased in 2007, adversely affecting prices, causing us to write less of this business. The business was very profitable in 2006 and 2007 because there were no catastrophe losses. However, we continue to reinsure much of our catastrophe exposure, buying substantial amounts of reinsurance on an excess of loss basis.

We underwrite property business specializing in risks of large, often multinational, corporations, covering a variety of commercial properties, which include but are not limited to:

|                   |                  |
|-------------------|------------------|
| factories         | office buildings |
| hotels            | retail locations |
| industrial plants | utilities        |

We have written property business since 1986, including business interruption, physical damage and catastrophe risks, such as flood and earthquake. Rates increased significantly following September 11, 2001, but trended downward by 2005 despite the hurricane activity in 2004. Massive losses from hurricanes in 2005 resulted in substantial rate increases, but due to over capacity, policy conditions have remained unchanged, unlike energy risks. Accordingly, we substantially reduced our involvement in policies with exposures in the Florida and U.S. Gulf Coast regions. We continue to buy substantial catastrophe reinsurance, unlike many industry participants, which was shown to be adequate during 2004 and 2005 when large amounts of industry capital were lost. While the hurricane activity seriously affected our earnings in the third quarters of 2004 and 2005, we still were able to produce record annual earnings in those years, and this business was profitable in 2006 and 2007 as there were no significant catastrophe losses.

We began writing London market accident and health risks in 1996, including trip accident, medical and disability. Due to past experience and other market factors, we significantly decreased premiums starting in 2004, although our business is now much more stable and profitable.

Our London market account is reinsured principally on an excess of loss basis. We closely monitor catastrophe exposure and purchase reinsurance to limit our net exposure to a level such that any loss is not expected to impact our capital. Previous net catastrophe losses from Hurricane Andrew in 1992, the Northridge Earthquake in 1994, the terrorist attacks on September 11, 2001, and the hurricanes of 2004 and 2005 did not exceed net earnings in the affected quarter.

***Other Specialty Lines***

In addition to the above, we underwrite various other specialty lines of business, including different types of property and liability business, for which individual premiums by type of business are not at this time significant to our overall results of operations.

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**Insurance Companies**

***Houston Casualty Company***

Houston Casualty Company is our largest insurance company subsidiary. It is domiciled in Texas and insures risks worldwide. Houston Casualty Company underwrites business produced by independent agents and brokers, affiliated underwriting agencies, one unaffiliated underwriting agency, reinsurance brokers, and other insurance and reinsurance companies. Houston Casualty Company writes diversified financial products, aviation, London market account and other specialty lines of business. Houston Casualty Company's 2007 gross written premium, including Houston Casualty Company-London, was \$664.6 million.

***Houston Casualty Company-London***

Houston Casualty Company operates a branch office in London, England, in order to more closely align its underwriting operations with the London market, a historical focal point for some of the business that it underwrites. Houston Casualty Company-London underwrites diversified financial products and London market account business, some of which is produced by our affiliated underwriting agencies. In 2006, we focused the underwriting activities of Houston Casualty Company-London's office on risks based in the United States. We began to use HCC International Insurance Company as a platform for much of the European and other international risks previously underwritten by Houston Casualty Company-London.

***HCC International Insurance Company***

HCC International Insurance Company PLC writes diversified financial products business, primarily surety, credit and professional indemnity products, and non-United States based London market account risks. HCC International Insurance Company has been in operation since 1982 and is domiciled in the United Kingdom. HCC International Insurance Company's 2007 gross written premium was \$230.2 million. We intend to continue to expand the underwriting activities of HCC International Insurance Company and to use it as an integral part of a European platform for our international insurance operations.

***U.S. Specialty Insurance Company***

U.S. Specialty Insurance Company is a Texas-domiciled property and casualty insurance company. It primarily writes diversified financial products, aviation and accident and health business. U.S. Specialty Insurance Company acts as an issuing carrier for certain business underwritten by our underwriting agencies. U.S. Specialty Insurance Company's gross written premium in 2007 was \$490.0 million.

***HCC Life Insurance Company***

HCC Life Insurance Company is an Indiana-domiciled life insurance company. It operates as a group life, accident and health insurer. This business is produced by unaffiliated agents, brokers and third party administrators. In early 2005, we consolidated the operations of our underwriting agency, HCC Benefits Corporation, into HCC Life Insurance Company. In 2006, the Health Products Division was acquired and integrated into HCC Life Insurance Company. HCC Life Insurance Company's gross written premium in 2007 was \$711.6 million.

***Avemco Insurance Company***

Avemco Insurance Company is a Maryland-domiciled property and casualty insurer and operates as a direct market underwriter of general aviation business. It has also been an issuing carrier for accident and health business and some other lines of business underwritten by our underwriting agencies and an affiliated underwriting agency. Avemco Insurance Company's gross written premium in 2007 was \$66.3 million.

*American Contractors Indemnity Company*

American Contractors Indemnity Company is a California-domiciled surety company. It writes court, specialty contract, license and permit, and bail bonds. American Contractors Indemnity Company has been in



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operation since 1990 and operates as a part of our HCC Surety Group. American Contractors Indemnity Company's 2007 gross written premium was \$96.7 million.

***HCC Europe***

Houston Casualty Company Europe, Seguros y Reaseguros, S.A. is a Spanish insurer. It underwrites diversified financial products business. HCC Europe is also an issuing carrier for business underwritten by our underwriting agencies and has been in operation since 1978. HCC Europe's gross written premium in 2007 was \$136.9 million.

***HCC Reinsurance Company***

HCC Reinsurance Company Limited is a Bermuda-domiciled reinsurance company that writes assumed reinsurance from our insurance companies and a limited amount of direct insurance. HCC Reinsurance Company is an issuing carrier for diversified financial products business underwritten by our underwriting agency, HCC Indemnity Guaranty. HCC Reinsurance Company also reinsures our proportional interests in Lloyd's of London Syndicates 4040 and 4141. HCC Reinsurance Company's gross written premium in 2007 was \$116.4 million.

***HCC Specialty Insurance Company***

HCC Specialty Insurance Company is an Oklahoma-domiciled property and casualty insurance company in operation since 2002. It writes diversified financial products and other specialty lines of business produced by affiliated underwriting agencies and one unaffiliated underwriting agency. HCC Specialty Insurance Company's gross written premium in 2007 was \$19.0 million and was 100% ceded to Houston Casualty Company.

***United States Surety Company***

United States Surety Company is a Maryland-domiciled surety company that has been in operation since 1996. It writes contract bonds and operates as a part of our HCC Surety Group. United States Surety Company's 2007 gross written premium was \$25.5 million.

***Perico Life Insurance Company***

Perico Life Insurance Company was a previously dormant company acquired in December 2005 and is a Delaware-domiciled life insurance company. Perico Life Insurance Company now operates as a group life, accident and health insurer. In 2006, we consolidated the operations of Perico Ltd. into Perico Life Insurance Company. Perico Life Insurance Company's 2007 gross written premium was \$47.2 million.

***HCC Insurance Company***

HCC Insurance Company is an Indiana-domiciled property and casualty insurance company. It writes business included in our other specialty lines of business that is produced by one of our underwriting agencies. HCC Insurance Company's gross written premium in 2007 was 100% ceded to Houston Casualty Company.

***Lloyd's of London Syndicates***

We currently have an 87% participation in Lloyd's of London Syndicate 4040, which writes business included in our other specialty lines of business, and a 100% participation in recently formed Lloyd's of London Syndicate 4141, which writes business in our group life, accident and health line of business. These syndicates are managed by HCC Underwriting Agency, Ltd. (UK). Our participation in these syndicates is reinsured by HCC Reinsurance Company.

We expect to use our Lloyd's of London platform and the licenses it affords us to write business that is unique to Lloyd's of London and to write business in countries where our other insurance companies are not currently licensed.

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**Underwriting Agency Operations**

Historically, we have acquired underwriting agencies with seasoned books of business and experienced underwriters. These agencies control the distribution of their business. After we acquire an agency, we generally begin to write some or all of its business through our insurance companies and in some cases the insurance companies reinsure some of the business with unaffiliated insurance companies. Over time, we retain greater percentages of this business, reducing the revenues of our underwriting agencies, but increasing our underwriting profits. We have also consolidated certain of our underwriting agencies with our insurance companies when our retention of their business approached 100%. We plan to continue this process into the future.

Our underwriting agencies act on behalf of affiliated and unaffiliated insurance companies and provide insurance underwriting management and claims administration services. Our underwriting agencies do not assume any insurance or reinsurance risk themselves and generate revenues based entirely on fee income and profit commissions. These subsidiaries are in a position to direct and control business they produce. Our insurance companies serve as policy issuing companies for the majority of the business written by our underwriting agencies. If an unaffiliated insurance company serves as the policy issuing company, our insurance companies may reinsure the business written by our underwriting agencies. Our underwriting agencies generated total revenue in 2007 of \$146.5 million.

***Professional Indemnity Agency***

Professional Indemnity Agency, Inc., based in Mount Kisco, New York and with operations in San Francisco, California, Concord, California, and Auburn Hills, Michigan, acts as an underwriting manager for diversified financial products specializing in directors and officers liability and professional indemnity, kidnap and ransom, employment practice liability, public entity, and other specialty lines of business on behalf of affiliated and unaffiliated insurance companies. It has been in operation since 1977.

***HCC Specialty Underwriters***

HCC Specialty Underwriters Inc., with its home office in Wakefield, Massachusetts and with branch offices in London, England, Los Angeles, California and New York, New York, acts as an underwriting manager for sports disability, contingency, film completion and other group life, accident and health and specialty lines of business on behalf of affiliated and unaffiliated insurance companies. It has been in operation since 1982.

***HCC Global Financial Products***

HCC Global Financial Products, LLC acts as an underwriting manager for diversified financial products, specializing in directors and officers liability business on behalf of affiliated insurance companies. It has been in operation since 1999, underwriting domestic business from Farmington, Connecticut, Jersey City, New Jersey and Houston, Texas and international business from Barcelona, Spain, London, England, and Miami, Florida.

***Covenant Underwriters***

Covenant Underwriters, Ltd. is an underwriting agency based in Covington, Louisiana with an office in New York, New York, specializing in commercial marine insurance underwritten on behalf of affiliated and unaffiliated insurance companies. It has been in operation through predecessor entities since 1993.

***HCC Indemnity Guaranty Agency***

HCC Indemnity Guaranty Agency, Inc. is an underwriting agency based in New York, New York, specializing in writing insurance and reinsurance related to various financial products. It writes on behalf of affiliated insurance companies. It has been in operation since 2004.

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***HCC Underwriting Agency, Ltd. (UK)***

HCC Underwriting Agency, Ltd. (UK) is a managing agent for two Lloyd's of London syndicates, which specialize in United Kingdom third party liability, employers' liability, commercial motor and short-term medical risks. One of our insurance companies is a participant in these syndicates, with our current participation of 87% in Syndicate 4040 and 100% in Syndicate 4141. We plan to use HCC Underwriting Agency, Ltd. (UK) and its managed syndicates as a platform for expanding our operations within the Lloyd's of London market. HCC Underwriting Agency, Ltd. (UK) has been in operation since 2004.

***MultiNational Underwriters, LLC***

MultiNational Underwriters, LLC, based in Indianapolis, Indiana, is an underwriting agency specializing in domestic and international short-term medical insurance, which is written principally through an internet platform. The domestic business is written on behalf of one of our domestic insurance companies and the international business is written by Lloyd's of London Syndicate 4141, which is managed by one of our subsidiaries and in which we have a 100% participation.

**Reinsurance and Insurance Broker Operations**

Our reinsurance and insurance brokers provide a variety of services, including marketing, placing, consulting on and servicing insurance risks for their clients, which include medium to large corporations, unaffiliated and affiliated insurance and reinsurance companies, and other risk-taking entities. The brokers earn commission income and, to a lesser extent, fees for certain services, which are generally paid by the underwriters with whom the business is placed. Some of these risks may be initially underwritten by our insurance companies and they may retain a portion of the risk. Total revenue generated by our brokers in 2007 amounted to \$32.1 million.

***Rattner Mackenzie***

Rattner Mackenzie Limited is a reinsurance broker based in London, England, with additional operations in Hamilton, Bermuda and Mt. Kisco, New York. Rattner Mackenzie specializes in group life, accident and health reinsurance and some specialty property and casualty lines of business. It operates as a Lloyd's of London broker for insurance and reinsurance business placed on behalf of unaffiliated and affiliated insurance companies, reinsurance companies and underwriting agencies and has been in operation since 1989.

***Continental Underwriters***

Continental Underwriters Ltd. is an insurance broker based in Covington, Louisiana, specializing in commercial marine insurance and has been in operation since 1970.

***HCC Risk Management***

HCC Risk Management Corporation, based in Houston, Texas, is a reinsurance broker specializing in placing reinsurance on behalf of affiliated and unaffiliated insurance companies and has been in operation since 1991.

**Other Operations**

Other operating income consists of the following:

Equity in the earnings of mainly insurance-related companies in which we invest;

Dividends and interest from certain other insurance-related strategic investments and gains or losses from the disposition of these investments;

Income related to two mortgage impairment insurance contracts which, while written as insurance policies, receive accounting treatment as derivative financial instruments;

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The profit or loss from a portfolio of trading securities; and

Other miscellaneous income.

Other operating income was \$43.5 million in 2007 and \$77.0 million in 2006, and can vary considerably from period to period depending on the amount of investment or disposition activity. In the fourth quarter of 2006, we began liquidating our trading portfolio, a process that was completed in 2007 with the exception of two investment positions. We invested the proceeds primarily in fixed income securities.

**Operating Ratios*****Premium to Surplus Ratio***

This table shows the ratio of statutory gross written premium and net written premium to statutory policyholders surplus for our property and casualty insurance companies (dollars in thousands):

|   | 2007         | 2006         | 2005         | 2004         | 2003         |
|---|--------------|--------------|--------------|--------------|--------------|
| Gross written premium                     | \$ 2,460,498 | \$ 2,243,843 | \$ 2,049,116 | \$ 1,992,361 | \$ 1,746,413 |
| Net written premium                       | 1,985,641    | 1,812,896    | 1,495,931    | 1,121,343    | 867,795      |
| <b>Policyholders surplus</b>              | 1,744,889    | 1,342,054    | 1,110,268    | 844,851      | 591,889      |
| Gross written premium ratio               | 141.0%       | 167.2%       | 184.6%       | 235.8%       | 295.1%       |
| Gross written premium industry average(1) | *            | 171.0%       | 192.7%       | 201.6%       | 219.3%       |
| Net written premium ratio                 | 113.8%       | 135.1%       | 134.7%       | 132.7%       | 146.6%       |
| Net written premium industry average(1)   | *            | 90.4%        | 99.8%        | 108.5%       | 117.4%       |

(1) Source: A.M. Best Company, Inc.

\* Not available

While there is no statutory requirement regarding a permissible premium to policyholders surplus ratio, guidelines established by the National Association of Insurance Commissioners provide that a property and casualty insurer's annual statutory gross written premium should not exceed 900% and net written premium should not exceed 300% of its policyholders surplus. However, industry and rating agency guidelines place these ratios at 300% and 200%, respectively. Our property and casualty insurance companies have maintained ratios lower than such guidelines.

***Combined Ratio GAAP***

The underwriting experience of a property and casualty insurance company is indicated by its combined ratio. The GAAP combined ratio is a combination of the loss ratio (the ratio of incurred losses and loss adjustment expenses to net earned premium) and the expense ratio (the ratio of policy acquisition costs and other underwriting expenses, net of ceding commissions, to net earned premium). We calculate the GAAP combined ratio using financial data derived from our consolidated financial statements reported under accounting principles generally accepted in the United States of America (generally accepted accounting principles). Our insurance companies' GAAP loss ratios, expense

ratios and combined ratios are shown in the following table:

|                            | <b>2007</b> | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|----------------------------|-------------|-------------|-------------|-------------|-------------|
| Loss ratio                 | 59.6%       | 59.2%       | 67.1%       | 63.8%       | 66.1%       |
| Expense ratio              | 23.8        | 25.0        | 26.1        | 26.7        | 24.6        |
| <b>Combined ratio GAAP</b> | 83.4%       | 84.2%       | 93.2%       | 90.5%       | 90.7%       |



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The statutory combined ratio is a combination of the loss ratio (the ratio of incurred losses and loss adjustment expenses to net earned premium) and the expense ratio (the ratio of policy acquisition costs and other underwriting expenses, net of ceding commissions, to net written premium). We calculate the statutory combined ratio using financial data derived from the combined financial statements of our insurance company subsidiaries reported in accordance with statutory accounting principles. Our insurance companies' statutory loss ratios, expense ratios and combined ratios are shown in the following table:

|                                 | 2007  | 2006  | 2005   | 2004  | 2003   |
|---------------------------------|-------|-------|--------|-------|--------|
| Loss ratio                      | 60.6% | 60.0% | 67.1%  | 64.3% | 66.8%  |
| Expense ratio                   | 23.9  | 24.0  | 25.5   | 26.7  | 23.0   |
| <b>Combined ratio Statutory</b> | 84.5% | 84.0% | 92.6%  | 91.0% | 89.8%  |
| Industry average                | *     | 92.5% | 100.7% | 98.3% | 100.1% |

\* Not available

The statutory ratio data is not intended to be a substitute for results of operations in accordance with generally accepted accounting principles. We believe including this information is useful to allow a comparison of our operating results with those of other companies in the insurance industry. The source of the industry average is A.M. Best Company, Inc. A.M. Best Company, Inc. reports insurer performance based on statutory financial data to provide more standardized comparisons among individual companies and to provide overall industry performance. This data is not an evaluation directed at investors.

**Reserves**

Our net loss and loss adjustment expense reserves are composed of reserves for reported losses and reserves for incurred but not reported losses, less a reduction for reinsurance recoverables related to those reserves. Reserves are recorded by product line and are undiscounted, except for reserves related to acquisitions.

The process of estimating our loss and loss adjustment expense reserves involves a considerable degree of judgment by management and is inherently uncertain. The recorded reserves represent management's best estimate of unpaid loss and loss adjustment expense by line of business. Because we provide insurance coverage in specialized lines of business that often lack statistical stability, management considers many factors and not just actuarial point estimates in determining ultimate expected losses and the level of net reserves required and recorded.

To record reserves on our lines of business, we utilize expected loss ratios, which management selects based on the following:

Information used to price the applicable policies;

Historical loss information where available;

Any public industry data for that line or similar lines of business; and

An assessment of current market conditions.

Management also considers the point estimates and ranges calculated by our actuaries, together with input from our experienced underwriting and claims personnel. Because of the nature and complexities of the specialized types of business we insure, management may give greater weight to the expectations of our underwriting and claims personnel, who often perform a claim by claim review, rather than to the actuarial estimates. However, we utilize the actuarial point and range estimates to monitor the adequacy and reasonableness of our recorded reserves.

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Each quarter-end, management compares recorded reserves to the most recent actuarial point estimate and range for each line of business. If the recorded reserves vary significantly from the actuarial point estimate, management determines the reasons for the variances and may adjust the reserves up or down to an amount that, in management's judgment, is adequate based on all of the facts and circumstances considered, including the actuarial point estimates. We consistently maintain total consolidated net reserves above the total actuarial point estimate but within the actuarial range.

Our actuaries utilize standard actuarial techniques in making their actuarial point estimates. These techniques require a high degree of judgment, and changing conditions can cause fluctuations in the reserve estimates. We believe that our review process is effective, such that any required changes are recognized in the period of change as soon as the need for the change is evident. Reinsurance recoverables offset our gross reserves based upon the contractual terms of our reinsurance agreements.

With the exception of 2004, our net reserves historically have shown favorable development except for the effects of losses from commutations, which we have completed in the past and may negotiate in the future. Commutations can produce adverse prior year development since, under generally accepted accounting principles, any excess of undiscounted reserves assumed over assets received must be recorded as a loss at the time the commutation is completed. Economically, the loss generally represents the discount for the time value of money that will be earned over the payout of the reserves; thus, the loss may be recouped as investment income is earned on the assets received. Based on our reserving techniques and our past results, we believe that our net reserves are adequate.

The reserving process is intended to reflect the impact of inflation and other factors affecting loss payments by taking into account changes in historical payment patterns and perceived trends. There is no precise method for the subsequent evaluation of the adequacy of the consideration given to inflation, or to any other specific factor, or to the way one factor may impact another.

We underwrite risks that are denominated in a number of foreign currencies and, therefore, maintain loss reserves with respect to these policies in the respective currencies. These reserves are subject to exchange rate fluctuations, which may have an effect on our net earnings.

The loss development triangles below show changes in our reserves in subsequent years from the prior loss estimates, based on experience at the end of each succeeding year, on the basis of generally accepted accounting principles. The estimate is increased or decreased as more information becomes known about the frequency and severity of losses for individual years. A redundancy means the original estimate was higher than the current estimate; a deficiency means that the current estimate is higher than the original estimate.

The first line of each loss development triangle presents, for the years indicated, our gross or net reserve liability, including the reserve for incurred but not reported losses. The first section of each table shows, by year, the cumulative amounts of loss and loss adjustment expense paid at the end of each succeeding year. The second section sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. The cumulative redundancy (deficiency) represents, at the date indicated, the difference between the latest re-estimated liability and the reserves as originally estimated.

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This loss development triangle shows development in loss reserves on a gross basis (in thousands):

|      | 2006         | 2005         | 2004         | 2003         | 2002         | 2001         | 2000         | 1999        |
|------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|-------------|
| 2007 | \$ 3,097,051 | \$ 2,813,720 | \$ 2,089,199 | \$ 1,525,313 | \$ 1,158,915 | \$ 1,132,258 | \$ 944,117   | \$ 871,104  |
|      |              |              |              |              | 5,587        |              | (66,571)     | (32,437)    |
| 2007 | 3,097,051    | 2,813,720    | 2,089,199    | 1,525,313    | 1,164,502    | 1,132,258    | 877,546      | 838,667     |
|      | 797,217      | 689,126      | 511,766      | 396,077      | 418,809      | 390,232      | 400,279      | 424,379     |
|      |              | 1,077,954    | 780,130      | 587,349      | 548,941      | 612,129      | 537,354      | 561,246     |
|      |              |              | 993,655      | 772,095      | 659,568      | 726,805      | 667,326      | 611,239     |
|      |              |              |              | 866,025      | 823,760      | 803,152      | 720,656      | 686,730     |
|      |              |              |              |              | 886,458      | 921,920      | 758,126      | 721,011     |
|      |              |              |              |              |              | 1,009,049    | 835,994      | 725,639     |
|      |              |              |              |              |              |              | 924,803      | 752,733     |
|      |              |              |              |              |              |              |              | 817,615     |
| 2007 | 3,097,051    | 2,813,720    | 2,089,199    | 1,525,313    | 1,164,502    | 1,132,258    | 877,546      | 838,667     |
|      | 3,006,430    | 2,810,419    | 2,118,471    | 1,641,426    | 1,287,003    | 1,109,098    | 922,080      | 836,775     |
|      |              | 2,698,947    | 2,112,303    | 1,666,931    | 1,393,143    | 1,241,261    | 925,922      | 868,438     |
|      |              |              | 2,025,133    | 1,690,729    | 1,464,448    | 1,384,608    | 1,099,657    | 854,987     |
|      |              |              |              | 1,619,744    | 1,506,360    | 1,455,046    | 1,102,636    | 900,604     |
|      |              |              |              |              | 1,453,674    | 1,480,193    | 1,135,143    | 887,272     |
|      |              |              |              |              |              | 1,433,630    | 1,137,652    | 894,307     |
|      |              |              |              |              |              |              | 1,079,353    | 899,212     |
|      |              |              |              |              |              |              |              | 879,805     |
|      | \$ 90,621    | \$ 114,773   | \$ 64,066    | \$ (94,431)  | \$ (289,172) | \$ (301,372) | \$ (201,807) | \$ (41,138) |

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The gross redundancies reflected in the above table for 2004 through 2006 resulted primarily from the following activity in 2007:

We recorded favorable development of \$46.5 million on certain run-off assumed accident and health reinsurance business reported in our discontinued lines of business due to our continuing evaluation of reserves, primarily on the 2000 accident year.

We recorded favorable development of \$44.1 million on our other lines of business. Most of this was from the 2003 and 2004 underwriting years in our diversified financial products line of business, which affected 2003 through 2005 accident years.

The gross deficiencies reflected in the above table for 1999 through 2003 resulted from the following:

During 2005, 2004 and 2003, we recorded \$49.8 million, \$127.7 million and \$132.9 million, respectively, in gross losses on certain run-off assumed accident and health reinsurance business reported in our discontinued lines of business, due to our processing of additional information received and our continuing evaluation of reserves on this business. Collectively, these transactions primarily affected the 1999, 2000 and 2001 accident years.

The 2000 and 1999 years in the table were also adversely affected by late reporting loss information received during 2001 for certain other discontinued business.

The gross reserves in the discontinued lines of business, particularly with respect to run-off assumed accident and health reinsurance business, produced substantial adverse development from 2003 through 2005, partially offset by a reduction in 2007. This assumed accident and health reinsurance is primarily excess coverage for large losses related to workers compensation policies. Losses tend to develop and affect excess covers considerably after the original loss was incurred. Additionally, certain primary insurance companies that we reinsured have experienced financial difficulty and some of them are in liquidation, with guaranty funds now responsible for administering the business. Losses related to this business are historically late reporting. While we attempt to anticipate these conditions in setting our gross reserves, we have only been partially successful to date and there could be additional adverse development in these reserves in the future. The gross losses that have developed adversely have been substantially reinsured and, therefore, the net effects have been much less.

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The following table provides a reconciliation of the gross liability for loss and loss adjustment expense payable on the basis of generally accepted accounting principles (in thousands):

|  | <b>2007</b>         | <b>2006</b>         | <b>2005</b>         |
|--|---------------------|---------------------|---------------------|
| Reserves for loss and loss adjustment expense payable at beginning of year                             | \$ 3,097,051        | \$ 2,813,720        | \$ 2,089,199        |
| Reserve additions from acquired businesses   | 826                 | 146,811             | 19,236              |
| Incurred loss and loss adjustment expense:   |                     |                     |                     |
| Provision for loss and loss adjustment expense for claims occurring in current year                    | 1,443,031           | 1,222,139           | 1,567,501           |
| Increase (decrease) in estimated loss and loss adjustment expense for claims occurring in prior years* | (90,621)            | (3,301)             | 29,272              |
| Incurred loss and loss adjustment expense  | 1,352,410           | 1,218,838           | 1,596,773           |
| Loss and loss adjustment expense payments for claims occurring during:                                 |                     |                     |                     |
| Current year   | 425,990             | 393,192             | 379,722             |
| Prior years  | 797,217             | 689,126             | 511,766             |
| Loss and loss adjustment expense payments  | 1,223,207           | 1,082,318           | 891,488             |
| <b>Reserves for loss and loss adjustment expense payable at end of year</b>                            | <b>\$ 3,227,080</b> | <b>\$ 3,097,051</b> | <b>\$ 2,813,720</b> |

\* Changes in loss and loss adjustment expense reserves for losses occurring in prior years reflect the gross effect of the resolution of losses for other than the reserve value and the subsequent adjustments of loss reserves.

The adverse development for 2005 was caused by increasing reserves on certain run-off assumed accident and health business reported in our discontinued lines, partially offset by reserve reductions on prior year hurricanes. The favorable development for 2007 was caused by decreasing reserves on the same run-off accident and health business, plus other reductions primarily from our diversified financial products line of business on the 2003 and 2004 underwriting years.

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This loss development triangle shows development in loss reserves on a net basis (in thousands):

|      | 2006         | 2005         | 2004         | 2003       | 2002       | 2001       | 2000       | 1999       |              |
|------|--------------|--------------|--------------|------------|------------|------------|------------|------------|--------------|
| 2007 | \$ 2,108,961 | \$ 1,533,433 | \$ 1,059,283 | \$ 705,200 | \$ 458,702 | \$ 313,097 | \$ 249,872 | \$ 273,606 | \$ 1,000,000 |
|      |              |              |              |            | 5,587      |            | (6,048)    | (3,343)    |              |
| 2006 | 2,108,961    | 1,533,433    | 1,059,283    | 705,200    | 464,289    | 313,097    | 243,824    | 270,263    | 1,000,000    |
|      | 556,096      | 222,336      | 172,224      | 141,677    | 115,669    | 126,019    | 102,244    | 145,993    | 1,000,000    |
|      |              | 420,816      | 195,663      | 135,623    | 152,674    | 131,244    | 139,659    | 174,534    | 1,000,000    |
|      |              |              | 337,330      | 124,522    | 115,214    | 163,808    | 118,894    | 185,744    | 1,000,000    |
|      |              |              |              | 217,827    | 88,998     | 93,405     | 138,773    | 180,714    | 1,000,000    |
|      |              |              |              |            | 155,708    | 59,936     | 158,935    | 197,416    | 1,000,000    |
|      |              |              |              |            |            | 125,311    | 137,561    | 200,833    | 1,000,000    |
|      |              |              |              |            |            |            | 194,517    | 188,901    | 1,000,000    |
|      |              |              |              |            |            |            |            | 244,069    | 1,000,000    |





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The net redundancies reflected in the above table for 2005 and 2006 resulted primarily from the following:

Reserve reductions in 2007 from the 2003 and 2004 underwriting years in our diversified financial products line of business, which primarily affected the 2003 through 2005 accident years.

Reserve reductions in 2006 on prior year hurricanes and aviation, affecting primarily the 2004 and 2005 accident years.

The net deficiencies reflected in the above table for 1999 through 2004 resulted primarily from activity on certain run-off assumed accident and health business reported in our discontinued lines of business, as follows:

Commutation charges of \$20.2 million, \$26.0 million and \$28.8 million recorded in 2006, 2005 and 2003, respectively.

Reserve strengthening of \$27.3 million in 2004 to bring net reserves above our actuarial point estimate.

Collectively, these transactions primarily affected the 1999, 2000 and 2001 accident years.

The table below provides a reconciliation of the liability for loss and loss adjustment expense payable, net of reinsurance ceded, on the basis of generally accepted accounting principles (in thousands):

|  | <b>2007</b>         | <b>2006</b>         | <b>2005</b>         |
|--|---------------------|---------------------|---------------------|
| Net reserves for loss and loss adjustment expense payable at beginning of year                         | \$ 2,108,961        | \$ 1,533,433        | \$ 1,059,283        |
| Net reserve additions from acquired businesses   | 742                 | 146,811             | 12,491              |
| Incurred loss and loss adjustment expense:   |                     |                     |                     |
| Provision for loss and loss adjustment expense for claims occurring in current year                    | 1,210,344           | 1,018,382           | 894,303             |
| Increase (decrease) in estimated loss and loss adjustment expense for claims occurring in prior years* | (26,397)            | (6,526)             | 25,394              |
| Incurred loss and loss adjustment expense  | 1,183,947           | 1,011,856           | 919,697             |
| Loss and loss adjustment expense payments for claims occurring during:                                 |                     |                     |                     |
| Current year   | 394,754             | 360,803             | 285,814             |
| Prior years  | 556,096             | 222,336             | 172,224             |
| Loss and loss adjustment expense payments  | 950,850             | 583,139             | 458,038             |
| <b>Net reserves for loss and loss adjustment expense payable at end of year</b>                        | <b>\$ 2,342,800</b> | <b>\$ 2,108,961</b> | <b>\$ 1,533,433</b> |

\*

Changes in loss and loss adjustment expense reserves for losses occurring in prior years reflect the net effect of the resolution of losses for other than the reserve value and the subsequent adjustments of loss reserves.

The adverse development for 2005 primarily related to a commutation charge from our reinsurance on certain run-off assumed accident and health business reported in our discontinued lines. The favorable development for 2006 related to a reduction in prior year hurricane reserves and a reduction in aviation reserves, mostly offset by another commutation charge on the run-off accident and health business. The favorable development for 2007 related primarily to reserve reductions in our diversified financial products line of business from the 2003 and 2004 underwriting years.

Deficiencies and redundancies in the reserves occur as we continually review our loss reserves with our actuaries, increasing or reducing loss reserves as a result of such reviews and as losses are finally settled and claims exposures are reduced. We believe we have provided for all material net incurred losses.

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We have no material exposure to asbestos claims or environmental pollution losses. Our largest insurance company subsidiary only began writing business in 1981, and its policies normally contain pollution exclusion clauses that limit pollution coverage to sudden and accidental losses only, thus excluding intentional dumping and seepage claims. Policies issued by our other insurance company subsidiaries do not have significant environmental exposures because of the types of risks covered.

## **Enterprise Risk Management**

In 2006, we began a formalized Enterprise Risk Management (ERM) initiative to provide us with a structured process for identifying business opportunities as well as downside risks or threats. This process will enable us to assess risks in a more transparent and consistent manner, resulting in improved recognition, management and monitoring of risk. With ERM, we are creating a risk awareness culture throughout the organization that will allow us to continue to achieve strong risk management practices. In support of our ERM initiative, a Corporate Vice President who reports to the President is responsible for implementation, professionals with ERM expertise assist us, and our Risk Committee oversees the process.

## **Regulation**

The business of insurance is extensively regulated by the government. At this time, the insurance business in the United States is regulated primarily by the individual states. Additional federal regulation of the insurance industry may occur in the future.

Our business depends on our compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. We devote a significant effort toward obtaining and maintaining our licenses and compliance with the diverse and complex regulatory structure. In all jurisdictions, the applicable laws and regulations are subject to amendment or interpretation by regulatory authorities. Generally, regulatory authorities are vested with broad discretion to grant, renew and revoke licenses and approvals and to implement regulations governing the business and operations of insurers, insurance agents, brokers and third party administrators.

## ***Insurance Companies***

Our insurance companies are subject to regulation and supervision by the states and by other jurisdictions in which they do business. Regulation by the states varies, but generally involves regulatory and supervisory powers of a state insurance official. In the United States, the regulation and supervision of our insurance operations relates primarily to:

- approval of policy forms and premium rates;
- licensing of insurers and their agents;
- periodic examinations of our operations and finances;
- prescribing the form and content of records of financial condition required to be filed;
- requiring deposits for the benefit of policyholders;
- requiring certain methods of accounting;
- requiring reserves for unearned premium, losses and other purposes;

restrictions on the ability of our insurance companies to pay dividends;

restrictions on the nature, quality and concentration of investments;

restrictions on transactions between insurance companies and their affiliates;

restrictions on the size of risks insurable under a single policy; and

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standards of solvency, including risk-based capital measurement (which is a measure developed by the National Association of Insurance Commissioners and used by state insurance regulators to identify insurance companies that potentially are inadequately capitalized).

In the United States, state insurance regulations are intended primarily for the protection of policyholders rather than shareholders. The state insurance departments monitor compliance with regulations through periodic reporting procedures and examinations. The quarterly and annual financial reports to the state insurance regulators utilize statutory accounting principles, which are different from the generally accepted accounting principles we use in our reports to shareholders. Statutory accounting principles, in keeping with the intent to assure the protection of policyholders, are generally based on a liquidation concept, while generally accepted accounting principles are based on a going-concern concept.

In the United States, state insurance regulators classify direct insurance companies and some individual lines of business as admitted (also known as licensed) insurance or non-admitted (also known as surplus lines) insurance. Surplus lines insurance is offered by non-admitted companies on risks that are not insured in the particular state by admitted companies. All surplus lines insurance is required to be written through licensed surplus lines insurance brokers, who are required to be knowledgeable of and to follow specific state laws prior to placing a risk with a surplus lines insurer. Our insurance companies offer products on both an admitted and surplus lines basis.

U.S. state insurance regulations also affect the payment of dividends and other distributions by insurance companies to their shareholders. Generally, insurance companies are limited by these regulations in the payment of dividends above a specified level. Dividends in excess of those thresholds are extraordinary dividends and are subject to prior regulatory approval. Many states require prior regulatory approval for all dividends.

In the United Kingdom, the Financial Services Authority supervises all securities, banking and insurance businesses, including Lloyd's of London. The Financial Services Authority oversees compliance with established periodic auditing and reporting requirements, risk assessment reviews, minimum solvency margins, dividend restrictions, restrictions governing the appointment of key officers, restrictions governing controlling ownership interests and various other requirements. All of our United Kingdom operations, including Houston Casualty Company-London, are authorized and regulated by the Financial Services Authority.

HCC Europe is domiciled in Spain and operates on the equivalent of an admitted basis throughout the European Union. HCC Europe's primary regulator is the Spanish General Directorate of Insurance and Pension Funds of the Ministry of the Economy and Treasury (Dirección General de Seguros y Fondos de Pensiones del Ministerio de Economía y Hacienda).

### ***Underwriting Agencies and Reinsurance and Insurance Brokers***

In addition to the regulation of insurance companies, the states impose licensing and other requirements on the underwriting agency and service operations of our other subsidiaries. These regulations relate primarily to:

advertising and business practice rules;

contractual requirements;

financial security;

licensing as agents, brokers, reinsurance brokers, managing general agents or third party administrators;

limitations on authority; and  
recordkeeping requirements.

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### ***Statutory Accounting Principles***

The principal differences between statutory accounting principles for our domestic insurance company subsidiaries and generally accepted accounting principles, the method by which we report our consolidated financial results to our shareholders, are as follows:

a liability is recorded for certain reinsurance recoverables under statutory accounting principles whereas, under generally accepted accounting principles, there is no such provision unless the recoverables are deemed to be doubtful of collection;

certain assets that are considered non-admitted assets are eliminated from a balance sheet prepared in accordance with statutory accounting principles, but are included in a balance sheet prepared in accordance with generally accepted accounting principles;

only some of the deferred tax asset is recognized under statutory accounting principles;

fixed income investments classified as available for sale are recorded at market value for generally accepted accounting principles and at amortized cost under statutory accounting principles;

outstanding losses and unearned premium are reported on a gross basis under generally accepted accounting principles and on a net basis under statutory accounting principles; and

under statutory accounting principles, policy acquisition costs are expensed as incurred and, under generally accepted accounting principles, such costs are deferred and amortized to expense as the related premium is earned.

Our international insurance company subsidiaries' accounting principles are prescribed by regulatory authorities in each country. The prescribed principles do not vary significantly from generally accepted accounting principles.

### ***Insurance Holding Company Acts***

Because we are an insurance holding company, we are subject to the insurance holding company system regulatory requirements of a number of states. Under these regulations, we are required to report information regarding our capital structure, financial condition and management. We are also required to provide prior notice to, or seek the prior approval of, insurance regulatory authorities of certain agreements and transactions between our affiliated companies. These agreements and transactions must satisfy certain regulatory requirements.

### ***Assessments***

Many states require insurers licensed to do business in the state to bear a portion of the loss suffered by some insureds as a result of the insolvency of other insurers or to bear a portion of the cost of insurance for high-risk or otherwise uninsured individuals. Depending upon state law, insurers can be assessed an amount that is generally limited to between 1% and 2% of premiums written for the relevant lines of insurance in that state. Part of these payments may be recoverable through premium rates, premium tax credits or policy surcharges. Significant increases in assessments could limit the ability of our insurance subsidiaries to recover such assessments through tax credits or other means. In addition, there have been some legislative efforts to limit policy surcharges or repeal the tax offset provisions. We cannot predict the extent to which such assessments may increase or whether there may be limits imposed on our ability to recover or offset such assessments.

***Insurance Regulations Concerning Change of Control***

Many state insurance regulatory laws contain provisions that require advance approval by state agencies of any change of control of an insurance company that is domiciled or, in some cases, has substantial business in that state. Control is generally presumed to exist through the ownership of 10% or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company.



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HCC owns, directly or indirectly, all of the shares of stock of insurance companies domiciled in a number of states. Any purchaser of shares of common stock representing 10% or more of the voting power of our common stock will be presumed to have acquired control of our domestic insurance subsidiaries unless, following application by that purchaser, the relevant state insurance regulators determine otherwise. Any transactions that would constitute a change in control of any of our individual insurance subsidiaries would generally require prior approval by the insurance departments of the states in which the insurance subsidiary is domiciled. Also, one of our insurance subsidiaries is domiciled in the United Kingdom and another in Spain. Insurers in those countries are also subject to change of control restrictions under their individual regulatory frameworks. These requirements may deter or delay possible significant transactions in our common stock or the disposition of our insurance companies to third parties, including transactions which could be beneficial to our shareholders.

### ***Risk-Based Capital***

The National Association of Insurance Commissioners has developed a formula for analyzing insurance companies called risk-based capital. The risk-based capital formula is intended to establish minimum capital thresholds that vary with the size and mix of an insurance company's business and assets. It is designed to identify companies with capital levels that may require regulatory attention. At December 31, 2007, each of our domestic insurance companies' total adjusted capital was significantly in excess of the authorized control level risk-based capital.

### ***Insurance Regulatory Information System***

The National Association of Insurance Commissioners has developed a rating system, the Insurance Regulatory Information System, primarily intended to assist state insurance departments in overseeing the financial condition of all insurance companies operating within their respective states. The Insurance Regulatory Information System consists of eleven key financial ratios that address various aspects of each insurer's financial condition and stability. Our insurance companies' Insurance Regulatory Information System ratios generally fall within the usual prescribed ranges.

### ***Terrorism Risk Insurance Act***

The Federal Terrorism Risk Insurance Act (TRIA) was initially enacted in 2002 for the purpose of ensuring the availability of insurance coverage for certain acts of terrorism, as defined in the TRIA. The Terrorism Risk Insurance Extension Act of 2005 extended TRIA through December 31, 2007. On December 26, 2007, the President signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2007 (Reauthorization Act). The Reauthorization Act extends the program through December 31, 2014. A major provision of the Reauthorization Act is the revision of the definition of Act of Terrorism to remove the requirement that the act of terrorism be committed by an individual acting on behalf of any foreign person or foreign interest in order to be certified under the Reauthorization Act. The Reauthorization Act sets the Federal share of compensation (subject to a \$100.0 million program trigger) for program years 2008-2014 at 85%, excess of our retention level, up to the maximum annual liability cap of \$100.0 billion.

Under the Reauthorization Act, we are required to offer terrorism coverage to our commercial policyholders in certain lines of business, for which we may, when warranted, charge an additional premium. The policyholders may or may not accept such coverage. The Reauthorization Act also established a deductible that each insurer would have to meet before Federal reimbursement would occur. For 2008, our deductible is approximately \$99.8 million.

### ***Legislative Initiatives***

In recent years, state legislatures have considered or enacted laws that modify and, in many cases, increase state authority to regulate insurance companies and insurance holding company systems. State insurance regulators are

members of the National Association of Insurance Commissioners, which seeks to promote uniformity of and to enhance the state regulation of insurance. In addition, the National Association

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of Insurance Commissioners and state insurance regulators, as part of the National Association of Insurance Commissioners state insurance department accreditation program and in response to new federal laws, have re-examined existing state laws and regulations, specifically focusing on insurance company investments, issues relating to the solvency of insurance companies, licensing and market conduct issues, streamlining agent licensing and policy form approvals, adoption of privacy rules for handling policyholder information, interpretations of existing laws, the development of new laws and the definition of extraordinary dividends.

In recent years, a variety of measures have been proposed at the federal level to reform the current process of Federal and state regulation of the financial services industries in the United States, which include the banking, insurance and securities industries. These measures, which are often referred to as financial services modernization, have as a principal objective the elimination or modification of regulatory barriers to cross-industry combinations involving banks, securities firms and insurance companies. A form of financial services modernization legislation was enacted at the Federal level in 1999 through the Gramm-Leach-Bliley Act. That Federal legislation was expected to have significant implications on the banking, insurance and securities industries and to result in more cross-industry consolidations among banks, insurance companies and securities firms and increased competition in many of the areas of operations. Such wide-spread cross-industry consolidation has not occurred to date. It also mandated the adoption of laws allowing reciprocity among the states in the licensing of agents and, along with other Federal laws, mandated the adoption of laws and regulations dealing with the protection of the privacy of policyholder information. Also, the Federal Government has from time to time considered whether to impose overall federal regulation of insurers. If so, we believe state regulation of the insurance business would likely continue. This could result in an additional layer of federal regulation. In addition, some insurance industry trade groups are actively lobbying for legislation that would allow an option for a separate Federal charter for insurance companies. The full extent to which the Federal Government could decide to directly regulate the business of insurance has not been determined by lawmakers.

State regulators in many states have initiated or are participating in industry-wide investigations of sales and marketing practices in the insurance industry. Such investigations have resulted in restitution and settlement payments by some companies and criminal charges against some individuals. The investigations have led to changes in the structure of compensation arrangements, the offering of certain products and increased transparency in the marketing of many insurance products. We have cooperated fully with any such investigations and, based on presently available information, do not expect any adverse results from such investigations.

We do not know at this time the full extent to which these Federal or state legislative or regulatory initiatives will or may affect our operations and no assurance can be given that they would not, if adopted, have a material adverse effect on our business or our results of operations.

## **Employees**

At December 31, 2007, we had 1,682 employees. Of this number, 938 are employed by our insurance companies, 470 are employed by our underwriting agencies, 97 are employed by our reinsurance and insurance brokers and 177 are employed at the corporate headquarters and elsewhere. We are not a party to any collective bargaining agreement and have not experienced work stoppages or strikes as a result of labor disputes. We consider our employee relations to be good.

## **Item 1A. Risk Factors**

### **Risks Relating to our Industry**

*Because we are a property and casualty insurer, our business may suffer as a result of unforeseen catastrophic losses.*

Property and casualty insurers are subject to claims arising from catastrophes. Catastrophic losses have had a significant impact on our historical results. Catastrophes can be caused by various events, including hurricanes, tsunamis, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires and

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may include man-made events, such as terrorist attacks. The incidence, frequency and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Insurance companies are not permitted to reserve for a catastrophe until it has occurred. Catastrophes can cause losses in a variety of our property and casualty lines, and most of our past catastrophe-related claims have resulted from hurricanes and earthquakes; however, we experienced a significant loss as a result of the September 11, 2001 terrorist attack. Most of our exposure to catastrophes comes from our London market account. Although we typically purchase reinsurance protection for risks we believe bear a significant level of catastrophe exposure, the nature or magnitude of losses attributed to a catastrophic event or events may result in losses that exceed our reinsurance protection. It is therefore possible that a catastrophic event or multiple catastrophic events could have a material adverse effect on our financial position, results of operations and liquidity.

***The insurance and reinsurance business is historically cyclical, and we expect to experience periods with excess underwriting capacity and unfavorable premium rates, which could cause our results to fluctuate.***

The insurance and reinsurance business historically has been a cyclical industry characterized by periods of intense price competition due to excessive underwriting capacity, as well as periods when shortages of capacity permitted an increase in pricing and, thus, more favorable premium levels. An increase in premium levels is often, over time, offset by an increasing supply of insurance and reinsurance capacity, either by capital provided by new entrants or by the commitment of additional capital by existing insurers or reinsurers, which may cause prices to decrease. Any of these factors could lead to a significant reduction in premium rates, less favorable policy terms and fewer opportunities to underwrite insurance risks, which could have a material adverse effect on our results of operations and cash flows. In addition to these considerations, changes in the frequency and severity of losses suffered by insureds and insurers may affect the cycles of the insurance and reinsurance business significantly. These factors may also cause the price of our common stock to be volatile.

***Our loss reserves are based on an estimate of our future liability, which may prove to be inadequate.***

We maintain loss reserves to cover our estimated liability for unpaid losses and loss adjustment expenses, including legal and other fees as well as a portion of our general expenses, for reported and unreported claims incurred at the end of each accounting period. Reserves do not represent an exact calculation of liability. Rather, reserves represent an estimate of what we expect the ultimate settlement and administration of claims will cost. These estimates, which generally involve actuarial projections, are based on our assessment of facts and circumstances then known, as well as estimates of future trends in claims severity, frequency, judicial theories of liability and other factors. These variables are affected by both internal and external events that could increase our exposure to losses including changes in claims handling procedures, inflation, judicial trends, legislative changes and current events, such as those recently affecting the credit markets. Many of these items are not directly quantifiable in advance. Additionally, there may be a significant reporting delay between the occurrence of the insured event and the time it is reported to us. The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to reserves are reflected in our results of operations in the periods in which such estimates are changed. Because setting reserves is inherently uncertain, there can be no assurance that current reserves will prove adequate in light of subsequent events. If actual claims prove to be greater than our reserves, our financial position, results of operations and liquidity may be adversely affected.

***The effects of emerging claim and coverage issues on our business are uncertain.***

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect our business by either extending coverage beyond our underwriting intent or by increasing the number or size of

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claims. In some instances, these changes may not become apparent until some time after we have issued insurance or reinsurance contracts that are affected by the changes. As a result, the full extent of liability under our insurance or reinsurance contracts may not be known for many years after a contract is issued and our financial position and results of operations may be adversely affected.

### ***We are subject to extensive governmental regulation, which could adversely affect our business.***

We are subject to extensive governmental regulation and supervision. Our business depends on compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Most insurance regulations are designed to protect the interests of policyholders rather than shareholders and other investors. In the United States, this regulation is generally administered by departments of insurance in each state in which we do business and includes a comprehensive framework of oversight of our operations and review of our financial position. U.S. Federal legislation may lead to additional federal regulation of the insurance industry in the coming years. Also, foreign governments regulate our international operations. Each foreign jurisdiction has its own unique regulatory framework that applies to our operations in that jurisdiction. Regulatory authorities have broad discretion to grant, renew or revoke licenses and approvals. Regulatory authorities may deny or revoke licenses for various reasons, including the violation of regulations. In some instances, we follow practices based on our interpretations of regulations, or those we believe to be generally followed by the industry, which may be different from the requirements or interpretations of regulatory authorities. If we do not have the requisite licenses and approvals and do not comply with applicable regulatory requirements, the insurance regulatory authorities could preclude or temporarily suspend us from carrying on some or all of our activities or otherwise penalize us. That type of action could have a material adverse effect on our results of operations. Also, changes in the level of regulation of the insurance industry (whether federal, state or foreign), or changes in laws or regulations themselves or interpretations by regulatory authorities, could have a material adverse effect on our business. Virtually all states require insurers licensed to do business in that state to bear a portion of the loss suffered by some insureds as the result of impaired or insolvent insurance companies. The effect of these arrangements could adversely affect our results of operations.

### ***Our reliance on brokers subjects us to their credit risk.***

In accordance with industry practice, we generally pay amounts owed on claims under our insurance and reinsurance contracts to brokers, and these brokers, in turn, pay these amounts to the clients that have purchased insurance or reinsurance from us. Although the law is unsettled and depends upon the facts and circumstances of the particular case, in some jurisdictions, if a broker fails to make such a payment, we might remain liable to the insured or ceding insurer for the deficiency. Conversely, in certain jurisdictions, when the insured or ceding insurer pays premiums for these policies to brokers for payment over to us, these premiums might be considered to have been paid and the insured or ceding insurer will no longer be liable to us for those amounts, whether or not we have actually received the premiums from the broker. Consequently, we assume a degree of credit risk associated with brokers with whom we transact business. However, due to the unsettled and fact-specific nature of the law, we are unable to quantify our exposure to this risk. To date, we have not experienced any material losses related to these credit risks.

## **Risks Relating to our Business**

### ***Our inability to accurately assess underwriting risk could reduce our net earnings.***

Our underwriting success is dependent on our ability to accurately assess the risks associated with the business on which the risk is retained. We rely on the experience of our underwriting staff in assessing these risks. If we fail to assess accurately the risks we retain, we may fail to establish appropriate premium rates and our reserves may be inadequate to cover our losses, which could reduce our net earnings. The underwriting process is further complicated

by our exposure to unpredictable developments, including earthquakes, weather-related events and other natural catastrophes, as well as war and acts of terrorism.



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***Our increased retentions in various lines of business expose us to a greater portion of potential losses.***

Over the past few years, we have significantly increased our retentions, or the part of the risk we retain for our own account, in a number of the lines of business underwritten by our insurance companies. The determination to reduce the amount of reinsurance we purchase or not to purchase reinsurance for a particular risk or line of business is based on a variety of factors including market conditions, pricing, availability of reinsurance, the level of our capital and loss history. Such determinations have the effect of increasing our financial exposure to losses associated with such risks or in the subject line of business and could have a material adverse effect on our financial position, results of operations and cash flows in the event of significant losses associated with such risks or lines of business.

***If we are unable to purchase adequate reinsurance protection for some of the risks we have underwritten, we will be exposed to any resulting losses.***

We purchase reinsurance for a portion of the risks underwritten by our insurance companies, especially volatile and catastrophe-exposed risks. Market conditions beyond our control determine the availability and cost of the reinsurance protection we purchase. In addition, the historical results of reinsurance programs and the availability of capital also affect the availability of reinsurance. Our reinsurance facilities are generally subject to annual renewal. We cannot assure that we can maintain our current reinsurance facilities or that we can obtain other reinsurance facilities in adequate amounts and at favorable rates. Further, we cannot determine what effect catastrophic losses will have on the reinsurance market in general and on our ability to obtain reinsurance in adequate amounts and at favorable rates in particular. If we are unable to renew or to obtain new reinsurance facilities, either our net exposures would increase or, if we are unwilling to bear such an increase, we would have to reduce the level of our underwriting commitments, especially in catastrophe-exposed risks. Either of these potential developments could have a material adverse effect on our financial position, results of operations and cash flows. The lack of available reinsurance may also adversely affect our ability to generate fee and commission income in our underwriting agency and reinsurance broker operations.

***If the companies that provide our reinsurance do not pay all of our claims, we could incur severe losses.***

We purchase reinsurance by transferring, or ceding, all or part of the risk we have assumed as a direct insurer to a reinsurance company in exchange for all or part of the premium we receive in connection with the risk. Through reinsurance, we have the contractual right to collect the amount reinsured from our reinsurers. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us, the reinsured, of our full liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. We cannot assure you that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis. Additionally, catastrophic losses from multiple direct insurers may accumulate within the more concentrated reinsurance market and result in claims that adversely impact the financial condition of such reinsurers and thus their ability to pay such claims. If we become liable for risks we have ceded to reinsurers or if our reinsurers cease to meet their obligations to us, whether because they are in a weakened financial position as a result of incurred losses or otherwise, our financial position, results of operations and cash flows could be materially adversely affected.

***As a direct insurer, we may have significant exposure for terrorist acts.***

To the extent that reinsurers have excluded coverage for terrorist acts or have priced such coverage at rates that we believe are not practical, we, in our capacity as a direct insurer, do not have reinsurance protection and are exposed for potential losses as a result of any terrorist acts. To the extent an act of terrorism is certified by the Secretary of Treasury, we may be covered under the Terrorism Risk Insurance Program Reauthorization Act of 2007, for up to 85% of our losses in 2008 up to the maximum amount set out in the Reauthorization Act. However, any such coverage

would be subject to a mandatory deductible. Our deductible under the Reauthorizaion Act during 2008 is approximately \$99.8 million.

In some jurisdictions outside of the United States, where we also have exposure to a loss from an act of terrorism, we have limited access to other government programs that may mitigate our exposure. If we become

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liable for risks that are not covered under the Reauthorization Act, our financial position, results of operations and cash flows could be materially adversely affected.

***We may be unsuccessful in competing against larger or more well-established business rivals.***

In our specialty insurance operations, we compete in narrowly-defined niche classes of business such as the insurance of private aircraft (aviation), directors and officers liability (diversified financial products), employer sponsored, self-insured medical plans (medical stop-loss), professional indemnity (diversified financial products) and surety (diversified financial products), as distinguished from such general lines of business as automobile or homeowners insurance. We compete with a large number of other companies in our selected lines of business, including: Lloyd's of London, ACE and XL in our London market business; American International Group and U.S. Aviation Insurance Group (a subsidiary of Berkshire Hathaway, Inc.) in our aviation line of business; United Health, Symetra Financial Corp. and Hartford Life in our group life, accident and health business; and American International Group, The Chubb Corporation, ACE, St. Paul Travelers and XL in our diversified financial products business. We face competition from specialty insurance companies, underwriting agencies and reinsurance brokers, as well as from diversified financial services companies that are larger than we are and that have greater financial, marketing and other resources than we do. Some of these competitors also have longer experience and more market recognition than we do in certain lines of business. In addition to competition in the operation of our business, we face competition from a variety of sources in attracting and retaining qualified employees. We cannot assure you that we will maintain our current competitive position in the markets in which we operate, or that we will be able to expand our operations into new markets. If we fail to do so, our results of operations and cash flows could be materially adversely affected.

***If rating agencies downgrade our financial strength ratings, our business and competitive position in the industry may suffer.***

Ratings have become an increasingly important factor in establishing the competitive position of insurance companies. Our insurance companies are rated by Standard & Poor's Corporation, Fitch Ratings and A.M. Best Company, Inc. The financial strength ratings reflect their opinions of an insurance company's and insurance holding company's financial strength, operating performance, strategic position and ability to meet its obligations to policyholders and are not evaluations directed to investors. Our ratings are subject to periodic review by those entities and the continuation of those ratings at current levels cannot be assured. If our ratings are reduced from their current levels, our financial position and results of operations could be adversely affected.

***We may require additional capital in the future, which may not be available or may only be available on unfavorable terms.***

Our future capital requirements depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. We may need to raise additional funds through financings or curtail our growth and reduce our assets. Any equity or debt financing, if available at all, may be on terms that are not favorable to us. In the case of equity financings, dilution to our shareholders could result and, in any case, such securities may have rights, preferences and privileges that are senior to those of our common stock. If we cannot obtain adequate capital on favorable terms or at all, our business, results of operations and liquidity could be adversely affected.

Standard & Poor's Corporation, Fitch Ratings and A.M. Best Company rate our credit strength. If our credit ratings are reduced, it might significantly impede our ability to raise capital and borrow money.

***We may be unable to attract and retain qualified employees.***

We depend on our ability to attract and retain experienced underwriting talent and other skilled employees who are knowledgeable about our business. Certain of our senior underwriters and other skilled employees have employment agreements that are for definite terms, and there is no assurance we will retain these employees beyond the current terms of their agreements. If the quality of our underwriting team and

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other personnel decreases, we may be unable to maintain our current competitive position in the specialized markets in which we operate and be unable to expand our operations into new markets, which could adversely affect our business.

***We invest a significant amount of our assets in fixed income securities that have experienced market fluctuations, which may greatly reduce the value of our investment portfolio.***

At December 31, 2007, \$3.7 billion of our \$4.7 billion investment portfolio was invested in fixed income securities. The fair value of these fixed income securities and the related investment income fluctuate depending on general economic and market conditions, including the recent downturn in the market due to subprime issues. For our fixed income securities, the fair value generally increases or decreases in an inverse relationship with fluctuations in interest rates, while net investment income realized by us from future investments in fixed income securities will generally increase or decrease with interest rates. Mortgage-backed and other asset-backed securities may have different net investment income and/or cash flows from those anticipated at the time of investment. These securities have prepayment risk when there is a risk that the timing of cash flows that result from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. Credit risk exists if mortgagees default on the underlying mortgages. Although we maintain an investment grade portfolio (99% are rated A or better), all of our fixed income securities are subject to credit risk. If any of the issuers of our fixed income securities suffer financial setbacks, the ratings on the fixed income securities could fall (with a concurrent fall in fair value) and, in a worst case scenario, the issuer could default on its financial obligations. If the issuer defaults, we could have realized losses associated with the impairment of the securities.

The impact of market fluctuations affects our financial statements. Because all of our fixed income securities are classified as available for sale, changes in the fair value of our securities are reflected in our other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our financial position. Unrealized pre-tax net investment gains (losses) on investments in fixed income securities were \$26.7 million in 2007, \$6.9 million in 2006 and \$(29.3) million in 2005.

In 2007 and continuing into 2008, the credit markets have been severely affected by various events. This has impacted interest rates and has caused large writedowns in other companies' financial instruments either due to the market fluctuations or the impact of the events on the debtors' financial condition. The continuing turmoil in the credit market could adversely affect the valuation of our investments and cause us to have to record realized impairment losses on our investments.

***Our strategy of acquiring other companies for growth may not succeed.***

Our strategy for growth includes growing through acquisitions of insurance industry related companies. This strategy presents risks that could have a material adverse effect on our business and financial performance, including: 1) the diversion of our management's attention, 2) our ability to assimilate the operations and personnel of the acquired companies, 3) the contingent and latent risks associated with the past operations of, and other unanticipated problems arising in, the acquired companies, 4) the need to expand management, administration and operational systems and 5) increased competition for suitable acquisition opportunities and qualified employees. We cannot predict whether we will be able to acquire additional companies on terms favorable to us or if we will be able to successfully integrate the acquired operations into our business. We do not know if we will realize any anticipated benefits of completed acquisitions or if there will be substantial unanticipated costs associated with new acquisitions. In addition, future acquisitions by us may result in potentially dilutive issuances of our equity securities, the incurrence of additional debt and/or the recognition of potential impairment of goodwill and other intangible assets. Each of these factors could adversely affect our financial position and results of operations.



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***We are exposed to goodwill impairment risk as part of our business acquisition strategy.***

We have recorded goodwill in connection with the majority of our business acquisitions. We are required to perform goodwill impairment tests at least annually and whenever events or circumstances indicate that the carrying value may not be recoverable from estimated future cash flows. As a result of our annual and other periodic evaluations, we may determine that a portion of the goodwill carrying value needs to be written down to fair value, which could adversely affect our financial position and results of operations.

***We are an insurance holding company and, therefore, may not be able to receive dividends in needed amounts from our subsidiaries.***

Historically, we have had sufficient cash flow from our non-insurance company subsidiaries to meet our corporate cash flow requirements for paying principal and interest on outstanding debt obligations, dividends to shareholders and corporate expenses. However, in the future we may rely on dividends from our insurance companies to meet these requirements. The payment of dividends by our insurance companies is subject to regulatory restrictions and will depend on the surplus and future earnings of these subsidiaries, as well as the regulatory restrictions. As a result, should our other sources of funds prove to be inadequate, we may not be able to receive dividends from our insurance companies at times and in amounts necessary to meet our obligations, which could adversely affect our financial position and liquidity.

***Because we operate internationally, fluctuations in currency exchange rates may affect our receivable and payable balances and our reserves.***

We underwrite insurance coverages that are denominated in a number of foreign currencies, and we establish and maintain our loss reserves with respect to these policies in their respective currencies. We hold assets denominated in comparable foreign currencies to hedge the foreign currency risk related to these reserves and other liabilities denominated in foreign currencies. Our net earnings could be adversely affected by exchange rate fluctuations if we do not hold offsetting positions. Our principal area of exposure relates to fluctuations in exchange rates between the major European currencies (particularly the British pound sterling and the Euro) and the U.S. dollar. Consequently, a change in the exchange rate between the U.S. dollar and the British pound sterling or the Euro could have an adverse effect on our results of operations.

***Our information technology systems may fail or suffer a loss of security, which could adversely affect our business.***

Our business is highly dependent upon the successful and uninterrupted functioning of our computer and data processing systems. We rely on these systems to perform actuarial and other modeling functions necessary for writing business, as well as to process and make claims payments. We have a highly trained staff that is committed to the development and maintenance of these systems. However, the failure of these systems could interrupt our operations. This could result in a material adverse effect on our business results.

In addition, a security breach of our computer systems could damage our reputation or result in liability. We retain confidential information regarding our business dealings in our computer systems. We may be required to spend significant capital and other resources to protect against security breaches or to alleviate problems caused by such breaches. It is critical that these facilities and infrastructure remain secure. Despite the implementation of security measures, this infrastructure may be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. In addition, we could be subject to liability if hackers were able to penetrate our network security or otherwise misappropriate confidential information.

***The SEC's inquiry related to our stock option granting procedures is ongoing, and the scope and outcome could have a negative impact on the price of our securities and on our business.***

In 2006, based on a voluntary independent investigation by a Special Committee of the Board of Directors of our past practices related to granting stock options, the SEC commenced an inquiry into our option pricing practices. We have provided the results of our internal review and independent investigation to the SEC, and we have responded to requests from the SEC for documents and additional information. We are



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fully cooperating with the SEC. We are unable to predict the outcome of the ongoing inquiry, but it may result in additional professional fees, including our advancement of attorneys' fees incurred by our directors, certain officers and certain former executives and Directors; may continue to occupy the time and attention of our management team; could trigger a downgrade in our financial strength ratings; could have a material adverse impact on our stock price, including increased stock price volatility; and could negatively impact our business and our ability to raise and borrow additional funds in the future. Furthermore, if we are subject to adverse findings in this or any other regulatory proceeding or governmental enforcement action, we could be required to pay damages and penalties or have other remedies imposed, which could harm our business, financial condition, results of operations and cash flows.

***We may not be able to delay or prevent an inadequate or coercive offer for change in control and regulatory rules and required approvals might delay or deter a favorable change of control.***

Our certificate of incorporation and bylaws do not have provisions that could make it more difficult for a third party to acquire a majority of our outstanding common stock. As a result, we may be more susceptible to an inadequate or coercive offer that could result in a change in control than a company whose charter documents have provisions that could delay or prevent a change in control.

Many state insurance regulatory laws contain provisions that require advance approval by state agencies of any change of control of an insurance company that is domiciled or, in some cases, has substantial business in that state. Control is generally presumed to exist through the ownership of 10% or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. We own, directly or indirectly, all of the shares of stock of insurance companies domiciled in a number of states. Any purchaser of shares of common stock representing 10% or more of the voting power of our common stock will be presumed to have acquired control of our domestic insurance subsidiaries unless, following application by that purchaser, the relevant state insurance regulators determine otherwise. Any transactions that would constitute a change in control of any of our individual insurance subsidiaries would generally require prior approval by the insurance departments of the states in which the insurance subsidiary is domiciled. Also, one of our insurance subsidiaries is domiciled in the United Kingdom and another in Spain. Insurers in those countries are also subject to change of control restrictions under their individual regulatory frameworks. These requirements may deter or delay possible significant transactions in our common stock or the disposition of our insurance companies to third parties, including transactions that could be beneficial to our shareholders.

**Item 1B. *Unresolved Staff Comments***

None.

**Item 2. *Properties***

Our principal and executive offices are located in Houston, Texas, in buildings owned by Houston Casualty Company. We also maintain offices in 45 locations elsewhere in the United States, the United Kingdom, Spain, Bermuda, Belgium and Ireland. The majority of these additional locations are in leased facilities. We are not dependent on our facilities to conduct business and such office space is suitable for the conduct of our business.

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Our principal office facilities are as follows:

| <b>Subsidiary</b>                                  | <b>Segment</b>                  | <b>Location</b>          | <b>Sq. Ft.</b> | <b>Termination Date of Lease</b> |
|--|---------------------------------|--------------------------|----------------|----------------------------------|
| HCC and Houston Casualty Company                   | Insurance Company and Corporate | Houston, Texas           | 51,000         | Owned                            |
| Houston Casualty Company                           | Insurance Company               | Houston, Texas           | 77,000         | Owned                            |
| Professional Indemnity Agency                      | Agency                          | Mount Kisco, New York    | 38,000         | Owned                            |
| HCC Life Insurance Company                         | Insurance Company               | Atlanta, Georgia         | 31,000         | December 31, 2011                |
| U.S. Specialty Insurance Company Aviation Division | Insurance Company               | Dallas, Texas            | 28,000         | August 31, 2013                  |
| HCC Specialty Underwriters                         | Agency                          | Wakefield, Massachusetts | 28,000         | December 31, 2010                |
| G. B. Kenrick & Associates, Inc.                   | Agency                          | Auburn Hills, Michigan   | 27,000         | May 31, 2012                     |
| HCC Surety Group                                   | Insurance Company               | Los Angeles, California  | 26,000         | May 31, 2009                     |
| Health Products Division                           | Insurance Company               | Minneapolis, Minnesota   | 25,000         | September 30, 2012               |
| HCC International and Rattner MacKenzie            | Insurance Company and Agency    | London, England          | 17,000         | December 24, 2015                |

See also Note 12 to our Consolidated Financial Statements included in this Form 10-K.

**Item 3. Legal Proceedings**

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

We are party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes over contractual relationships with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable.

In addition to the litigation discussed above, the following lawsuits related to the outcome of our stock option investigation have been filed:

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

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the Court will hold a final hearing. At the final hearing, we intend to seek final approval of the settlement. Under the terms of the settlement, we have or will implement certain corporate governance reforms. We and our directors and officers liability insurers have agreed to pay up to \$3.0 million to plaintiff s counsel for their attorneys fees, subject to approval by the Court.

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

In each of these lawsuits, certain of our current and former officers and directors have requested that they be indemnified for any losses and that their legal fees be advanced. Pursuant to our bylaws, our charter, applicable law and certain agreements entered into with some of the defendants, we are currently advancing legal fees.

Although the ultimate outcome of the above matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

**Item 4. *Submission of Matters to a Vote of Security Holders***

There were no matters submitted to a vote of security holders during the fourth quarter of 2007.

**Table of Contents****PART II****Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****Price Range of Common Stock**

Our common stock trades on the New York Stock Exchange under the ticker symbol HCC .

The intra-day high and low sales prices for quarterly periods from January 1, 2006 through December 31, 2007, as reported by the New York Stock Exchange, were as follows:

|                | 2007     |          | 2006     |          |
|----------------|----------|----------|----------|----------|
|                | High     | Low      | High     | Low      |
| First quarter  | \$ 32.89 | \$ 29.39 | \$ 34.89 | \$ 29.25 |
| Second quarter | 34.45    | 30.43    | 34.92    | 28.51    |
| Third quarter  | 34.21    | 25.12    | 33.99    | 28.82    |
| Fourth quarter | 31.64    | 27.99    | 35.15    | 28.81    |

On February 15, 2008, the last reported sales price of our common stock as reported by the New York Stock Exchange was \$27.03 per share.

**Shareholders**

We have one class of authorized capital stock: 250.0 million shares of common stock, par value \$1.00 per share. On February 15, 2008, there were 115.3 million shares of issued and outstanding common stock held by 781 shareholders of record; however, we estimate there are approximately 64,000 beneficial owners.

**Dividend Policy**

Cash dividends declared on a quarterly basis in 2007 and 2006 were as follows:

|                | 2007    | 2006    |
|----------------|---------|---------|
| First quarter  | \$ .100 | \$ .075 |
| Second quarter | .100    | .100    |
| Third quarter  | .110    | .100    |
| Fourth quarter | .110    | .100    |

Beginning in June 1996, we announced a planned quarterly program of paying cash dividends to shareholders. Our Board of Directors may review our dividend policy from time to time and any determination with respect to future dividends will be made in light of regulatory and other conditions at that time, including our earnings, financial condition, capital requirements, loan covenants and other related factors. Under the terms of our bank loan facility, we are prohibited from paying dividends in excess of an agreed upon maximum amount in any year. That limitation

should not affect our ability to pay dividends in a manner consistent with our past practice and current expectations.

**Table of Contents****Performance Graph**

The following graph shows a comparison of cumulative total returns for an investment of \$100.00 made on December 31, 2002 in the common stock of HCC Insurance Holdings, Inc., the Standard & Poor's Composite 1500 Index and the Standard & Poor's Midcap 400 Index. The graph assumes that all dividends were reinvested.

**COMPARISON OF CUMULATIVE FIVE YEAR TOTAL RETURN**

**Total Return to Shareholders  
(Includes reinvestment of dividends)**

| <b>Company/Index</b>         | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
|------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| HCC Insurance Holdings, Inc. | \$ 100.00   | \$ 130.52   | \$ 137.30   | \$ 186.94   | \$ 204.49   | \$ 185.32   |
| S&P Composite 1500 Index     | 100.00      | 129.59      | 144.85      | 153.04      | 176.51      | 186.17      |
| S&P Midcap 400 Index         | 100.00      | 135.62      | 157.97      | 177.81      | 196.16      | 211.81      |

This performance graph shall not be deemed to be incorporated by reference into our Securities and Exchange Commission filings and should not constitute soliciting material or otherwise be considered filed under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended.

**Table of Contents****Item 6. Selected Financial Data**

The selected consolidated financial data set forth below has been derived from the Consolidated Financial Statements. All information contained herein should be read in conjunction with the Consolidated Financial Statements, the related Notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Report.

|   | <b>Years Ended December 31,</b>              |                   |                   |                   |                   |
|---|--|-------------------|-------------------|-------------------|-------------------|
|   | <b>2007</b>                                  | <b>2006</b>       | <b>2005</b>       | <b>2004</b>       | <b>2003</b>       |
|   | <b>(in thousands, except per share data)</b> |                   |                   |                   |                   |
| <b>Statement of earnings data:</b>                            |  |                   |                   |                   |                   |
| Revenue   |  |                   |                   |                   |                   |
| Net earned premium  | \$ 1,985,086                                 | \$ 1,709,189      | \$ 1,369,988      | \$ 1,010,692      | \$ 738,272        |
| Fee and commission income                                     | 140,092                                      | 137,131           | 132,628           | 183,802           | 142,615           |
| Net investment income   | 206,462                                      | 152,804           | 98,851            | 64,885            | 47,335            |
| Net realized investment gain (loss)                           | 13,188                                       | (841)             | 1,448             | 5,822             | 527               |
| Other operating income  | 43,545                                       | 77,012            | 39,773            | 19,406            | 13,215            |
| <b>Total revenue</b>  | <b>2,388,373</b>                             | <b>2,075,295</b>  | <b>1,642,688</b>  | <b>1,284,607</b>  | <b>941,964</b>    |
| Expense   |  |                   |                   |                   |                   |
| Loss and loss adjustment expense, net                         | 1,183,947                                    | 1,011,856         | 919,697           | 645,230           | 488,000           |
| Policy acquisition costs, net                                 | 366,610                                      | 319,885           | 261,708           | 222,323           | 137,212           |
| Other operating expense                                       | 241,642                                      | 222,324           | 180,990           | 168,045           | 144,574           |
| Interest expense  | 10,304                                       | 11,396            | 7,684             | 8,374             | 7,453             |
| <b>Total expense</b>  | <b>1,802,503</b>                             | <b>1,565,461</b>  | <b>1,370,079</b>  | <b>1,043,972</b>  | <b>777,239</b>    |
| Earnings from continuing operations before income tax expense |  |                   |                   |                   |                   |
|   | 585,870                                      | 509,834           | 272,609           | 240,635           | 164,725           |
| Income tax expense on continuing operations                   | 190,441                                      | 167,549           | 84,177            | 81,940            | 59,382            |
| Earnings from continuing operations                           | 395,429                                      | 342,285           | 188,432           | 158,695           | 105,343           |
| Earnings from discontinued operations, net of income taxes(1) |  |                   | 2,760             | 4,004             | 36,684            |
| <b>Net earnings</b>   | <b>\$ 395,429</b>                            | <b>\$ 342,285</b> | <b>\$ 191,192</b> | <b>\$ 162,699</b> | <b>\$ 142,027</b> |
| <b>Basic earnings per share data:</b>                         |  |                   |                   |                   |                   |
| Earnings from continuing operations                           | \$ 3.50                                      | \$ 3.08           | \$ 1.78           | \$ 1.63           | \$ 1.11           |
|   |  |                   | 0.03              | 0.04              | 0.39              |



## Earnings from discontinued operations(1)

|                     |    |      |    |      |    |      |    |      |    |      |
|---------------------|----|------|----|------|----|------|----|------|----|------|
| <b>Net earnings</b> | \$ | 3.50 | \$ | 3.08 | \$ | 1.81 | \$ | 1.67 | \$ | 1.50 |
|---------------------|----|------|----|------|----|------|----|------|----|------|

|                                     |  |         |  |         |  |         |  |        |  |        |
|-------------------------------------|--|---------|--|---------|--|---------|--|--------|--|--------|
| Weighted average shares outstanding |  | 112,873 |  | 111,309 |  | 105,463 |  | 97,257 |  | 94,919 |
|-------------------------------------|--|---------|--|---------|--|---------|--|--------|--|--------|

**Diluted earnings per share data:**

|                                     |    |      |    |      |    |      |    |      |    |      |
|-------------------------------------|----|------|----|------|----|------|----|------|----|------|
| Earnings from continuing operations | \$ | 3.38 | \$ | 2.93 | \$ | 1.72 | \$ | 1.61 | \$ | 1.09 |
|-------------------------------------|----|------|----|------|----|------|----|------|----|------|

|  |  |  |  |  |  |      |  |      |  |      |
|--|--|--|--|--|--|------|--|------|--|------|
| Earnings from discontinued operations(1) |  |  |  |  |  | 0.03 |  | 0.04 |  | 0.38 |
|--|--|--|--|--|--|------|--|------|--|------|

|                     |    |      |    |      |    |      |    |      |    |      |
|---------------------|----|------|----|------|----|------|----|------|----|------|
| <b>Net earnings</b> | \$ | 3.38 | \$ | 2.93 | \$ | 1.75 | \$ | 1.65 | \$ | 1.47 |
|---------------------|----|------|----|------|----|------|----|------|----|------|

|                                     |  |         |  |         |  |         |  |        |  |        |
|-------------------------------------|--|---------|--|---------|--|---------|--|--------|--|--------|
| Weighted average shares outstanding |  | 116,997 |  | 116,736 |  | 109,437 |  | 98,826 |  | 96,576 |
|-------------------------------------|--|---------|--|---------|--|---------|--|--------|--|--------|

|                                    |    |       |    |       |    |       |    |       |    |       |
|------------------------------------|----|-------|----|-------|----|-------|----|-------|----|-------|
| Cash dividends declared, per share | \$ | 0.420 | \$ | 0.375 | \$ | 0.282 | \$ | 0.213 | \$ | 0.187 |
|------------------------------------|----|-------|----|-------|----|-------|----|-------|----|-------|

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|   | <b>2007</b>                                  | <b>2006</b>      | <b>December 31,<br/>2005</b> | <b>2004</b>      | <b>2003</b>      |
|---|--|------------------|------------------------------|------------------|------------------|
|   | <b>(in thousands, except per share data)</b> |                  |                              |                  |                  |
| <b>Balance sheet data:</b>                  |  |                  |                              |                  |                  |
| Total investments                           | \$ 4,672,277                                 | \$ 3,927,995     | \$ 3,257,428                 | \$ 2,468,491     | \$ 1,707,300     |
| Premium, claims and other<br>receivables    | 763,401                                      | 864,705          | 884,654                      | 891,360          | 934,252          |
| Reinsurance recoverables                    | 956,665                                      | 1,169,934        | 1,361,983                    | 1,104,026        | 900,775          |
| Ceded unearned premium                      | 244,684                                      | 226,125          | 239,416                      | 311,973          | 291,591          |
| Goodwill                                    | 776,046                                      | 742,677          | 532,947                      | 444,031          | 388,023          |
| <b>Total assets</b>                         | <b>8,074,645</b>                             | <b>7,630,132</b> | <b>7,028,800</b>             | <b>5,900,568</b> | <b>4,883,345</b> |
| Loss and loss adjustment expense<br>payable | 3,227,080                                    | 3,097,051        | 2,813,720                    | 2,089,199        | 1,525,313        |
| Unearned premium                            | 943,946                                      | 920,350          | 807,109                      | 741,706          | 592,311          |
| Premium and claims payable                  | 497,974                                      | 646,224          | 753,859                      | 766,765          | 784,038          |
| Notes payable                               | 324,714                                      | 308,887          | 309,543                      | 311,277          | 310,404          |
| <b>Shareholders equity</b>                  | <b>2,440,365</b>                             | <b>2,042,803</b> | <b>1,690,435</b>             | <b>1,325,498</b> | <b>1,046,405</b> |
| Book value per share(2)                     | \$ 21.21                                     | \$ 18.28         | \$ 15.26                     | \$ 12.99         | \$ 10.91         |

(1) We sold our retail brokerage operation, HCC Employee Benefits, Inc., in 2003. The net earnings of HCC Employee Benefits, the 2003 gain on sale and the subsequent gains in 2004 and 2005 from a contractual earnout are classified as discontinued operations. Consistent with this presentation, all pre-sale revenue and expense of HCC Employee Benefits was reclassified to discontinued operations.

(2) Book value per share is calculated by dividing outstanding shares into total shareholders equity.

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**Item 7. *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 Selected Financial Data, the Consolidated Financial Statements and the related Notes thereto.

**Overview**

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain, Bermuda, Belgium and Ireland transacting business in more than 100 countries. Our group consists of insurance companies, underwriting agencies and brokers. Our shares are traded on the New York Stock Exchange, and we had a market capitalization of \$3.1 billion at February 15, 2008. We earned \$395.4 million or \$3.38 per diluted share in 2007, compared to \$342.3 million or \$2.93 per diluted share in 2006. The increase in earnings in 2007 was due to increased earned premium, higher investment income and increased underwriting profit. We grew shareholders' equity by 19% in 2007 to \$2.4 billion at December 31, 2007, principally from net earnings.

We underwrite a variety of specialty lines of business identified as diversified financial products; group life, accident and health; aviation; London market account; and other specialty lines of business. Products in each line are marketed by our insurance companies and agencies, through a network of independent agents and brokers, directly to customers or through third party administrators. With the exception of our public company directors' and officers' liability business, certain international aviation and special financial product risks, and our London market business, the majority of our business is generally lower limit, smaller premium business that is less susceptible to price competition, severity of loss or catastrophe risk.

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

We generate our revenue from five primary sources:

Risk-bearing earned premium produced by our insurance company operations;

Non-risk-bearing fee and commission income received by our underwriting agency and broker operations;

Ceding commissions in excess of policy acquisition costs earned by our insurance company operations;

Investment income earned by all of our operations; and

Other operating income.

We produced \$2.4 billion of revenue in 2007, an increase of 15% over 2006, primarily from higher net earned premium, which resulted from both recent acquisitions and organic growth in certain lines of business, and from increased investment income.

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



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Our major acquisitions during the past three years are listed below. Net earnings and cash flows from each acquired entity are included in our operations beginning on the effective date of each transaction.

| <b>Company</b>   | <b>Segment</b>    | <b>Effective Date Acquired</b> |
|--|-------------------|--------------------------------|
| United States Surety Company                                       | Insurance Company | March 1, 2005                  |
| HCC International Insurance Company                                | Insurance Company | July 1, 2005                   |
| Perico Life Insurance Company                                      | Insurance Company | November 30, 2005              |
| Perico Ltd.  | Agency            | December 1, 2005               |
| HCCL Holdings Limited (UK) (formerly Illium Insurance Group, Ltd.) | Agency            | December 31, 2005              |
| G.B. Kenrick & Associates, Inc.                                    | Agency            | July 1, 2006                   |
| Health Products Division (Allianz Life Insurance Company)          | Insurance Company | October 2, 2006                |

The following section discusses our key operating results. The reasons for any significant variations between 2006 and 2005 are the same as those discussed for variations between 2007 and 2006, unless otherwise noted. Amounts in the following tables are in thousands, except for earnings per share, percentages, ratios and number of employees.

**Results of Operations**

Net earnings increased 16% to \$395.4 million (\$3.38 per diluted share) in 2007 from \$342.3 million (\$2.93 per diluted share) in 2006. The increase in 2007 net earnings resulted from growth in underwriting profits, the absence of a large commutation loss, favorable prior year loss reserve development, and higher net investment income. Net earnings increased 79% to \$342.3 million (\$2.93 per diluted share) in 2006 from \$191.2 million (\$1.75 per diluted share) in 2005. Net earnings in 2006 included after-tax losses of \$13.1 million (\$0.11 per diluted share) due to a reinsurance commutation and \$9.3 million (\$0.08 per diluted share) for costs related to our stock option investigation. Net earnings in 2005 included after-tax losses of \$58.2 million (\$0.53 per diluted share) due to the combined effects of five hurricanes and \$16.9 million (\$0.15 per diluted share) due to a reinsurance commutation. Growth in underwriting profit, net investment income, other operating income, favorable prior year loss development and the lack of hurricane losses contributed to the increase in 2006 net earnings.

During 2006 and 2005, we reached agreements with various reinsurers to commute two large reinsurance contracts related to certain run-off assumed accident and health reinsurance business included in our discontinued lines, for which we had reinsurance recoverables of \$120.2 million in 2006 and \$145.7 million in 2005 at the date of commutation. In consideration for discounting the recoverables and reassuming the associated loss reserves, we agreed to accept cash payments that were less than the related recoverables. We recorded pre-tax losses of \$20.2 million in 2006 and \$26.0 million in 2005 related to these commutations, which were included in loss and loss adjustment expense in our insurance company segment. We expect to recoup these losses over future years as we earn interest on the cash proceeds from the commutations prior to the related claims being paid.

In 2005, the property and casualty insurance industry suffered record losses from five major hurricanes that affected the Gulf Coast of the United States. We recorded gross losses of \$394.6 million from these hurricanes in 2005. Recoveries expected from our reinsurance programs reduced this gross loss to a pre-tax loss of \$89.7 million. This pre-tax loss was after reinsurance recoveries and included the cost of premiums to reinstate our reinsurance protection. There were no major hurricane losses in 2007 or 2006.

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

|   | <b>2007</b>  | <b>2006</b>  | <b>2005</b>  |
|---|--------------|--------------|--------------|
| Net earned premium  | 83.1%        | 82.3%        | 83.4%        |
| Fee and commission income                                     | 5.9          | 6.6          | 8.1          |
| Net investment income   | 8.6          | 7.4          | 6.0          |
| Net realized investment gain                                  | 0.6          |              | 0.1          |
| Other operating income  | 1.8          | 3.7          | 2.4          |
| <b>Total revenue</b>  | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> |
| Loss and loss adjustment expense, net                         | 49.6         | 48.8         | 56.0         |
| Policy acquisition costs, net                                 | 15.4         | 15.4         | 15.9         |
| Other operating expense                                       | 10.1         | 10.7         | 11.0         |
| Interest expense  | 0.4          | 0.5          | 0.5          |
| Earnings from continuing operations before income tax expense | 24.5         | 24.6         | 16.6         |
| Income tax expense  | 7.9          | 8.1          | 5.1          |
| <b>Earnings from continuing operations</b>                    | <b>16.6%</b> | <b>16.5%</b> | <b>11.5%</b> |

Total revenue increased 15% to \$2.4 billion in 2007 and 26% to \$2.1 billion in 2006, driven by significant growth in net earned premium and higher investment income and, in 2006, higher other operating income. Approximately 55% of the increase in revenue in 2007 and 28% in 2006 was due to the acquisition of businesses.

Gross written premium, net written premium and net earned premium are detailed below. Premium increased in 2007 principally as a result of acquisitions. See the Insurance Company Segment section below for further discussion of the relationship and changes in our premium revenue.

|                       | <b>2007</b>  | <b>2006</b>  | <b>2005</b>  |
|-----------------------|--------------|--------------|--------------|
| Gross written premium | \$ 2,451,179 | \$ 2,235,648 | \$ 2,038,286 |
| Net written premium   | 1,985,609    | 1,812,552    | 1,501,224    |
| Net earned premium    | 1,985,086    | 1,709,189    | 1,369,988    |

The table below shows the source of our fee and commission income.

|                                  | <b>2007</b>       | <b>2006</b>       | <b>2005</b>       |
|----------------------------------|-------------------|-------------------|-------------------|
| Agencies                         | \$ 92,230         | \$ 92,566         | \$ 94,972         |
| Insurance companies              | 47,862            | 44,565            | 37,656            |
| <b>Fee and commission income</b> | <b>\$ 140,092</b> | <b>\$ 137,131</b> | <b>\$ 132,628</b> |

The sources of net investment income are detailed below.

|                                | <b>2007</b>       | <b>2006</b>       | <b>2005</b>      |
|--------------------------------|-------------------|-------------------|------------------|
| Fixed income securities        | \$ 150,594        | \$ 112,878        | \$ 77,842        |
| Short-term investments         | 37,764            | 30,921            | 21,208           |
| Other investments              | 23,930            | 14,178            | 3,615            |
| <b>Total investment income</b> | <b>212,288</b>    | <b>157,977</b>    | <b>102,665</b>   |
| Investment expense             | (5,826)           | (5,173)           | (3,814)          |
| <b>Net investment income</b>   | <b>\$ 206,462</b> | <b>\$ 152,804</b> | <b>\$ 98,851</b> |

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Net investment income increased 35% in 2007 and 55% in 2006. These increases were primarily due to higher investment assets, which increased to \$4.7 billion at December 31, 2007 compared to \$3.9 billion at December 31, 2006 and \$3.3 billion at December 31, 2005, and higher interest rates. The growth in investment assets resulted from the following: cash flow from operations; higher retentions; commutations of reinsurance recoverables; our public offerings of common stock in 2005; and the increase in net loss reserves, particularly from our diversified financial products line of business, which generally has a longer time period between reporting and payment of claims. Average yields on our short-term investments increased from 4.5% in 2006 to 5.2% in 2007 and our long-term tax equivalent yield increased from 5.2% in 2006 to 5.4% in 2007. We continue to invest our funds primarily in fixed income securities, with a weighted average duration of 4.9 years at December 31, 2007.

At December 31, 2007, our unrealized gain on fixed income securities was \$25.0 million, compared to an unrealized loss of \$1.6 million at December 31, 2006, due to fluctuations in market interest rates. The change in the unrealized gain or loss, net of the related income tax effect, is recorded in other comprehensive income and fluctuates with changes in market interest rates. Our general policy has been to hold our fixed income securities, which are classified as available for sale, through periods of fluctuating interest rates and to not realize significant gains or losses from their sale. The unrealized gain on our fixed income securities increased to \$72.7 million at January 31, 2008 due to a decrease in interest rates.

In 2007, we had a \$13.2 million net realized investment gain compared to a net loss of \$0.8 million in 2006 and a net gain of \$1.4 million in 2005. The 2007 gain included \$13.4 million of embedded currency conversion gains on certain available for sale fixed income securities that we sold in December 2007. These securities were denominated in foreign currencies and were purchased to economically hedge liabilities, principally loss and loss expense payables, denominated in matching functional currencies. This realized gain was offset by a \$13.4 million foreign currency loss recorded in other operating expense. See the discussion of other operating expense below.

Other operating income decreased \$33.5 million in 2007 and increased \$37.2 million in 2006. The 2007 decrease and the 2006 increase were due to changes in the net gains from trading securities and the sales of strategic investments. Period to period comparisons in this category may vary substantially depending on market values of trading securities and other financial instruments and on income from strategic investments or dispositions of such investments. The following table details the components of other operating income.

|                               | <b>2007</b>      | <b>2006</b>      | <b>2005</b>      |
|-------------------------------|------------------|------------------|------------------|
| Strategic investments         | \$ 27,627        | \$ 43,627        | \$ 10,241        |
| Trading securities            | 3,881            | 24,100           | 16,619           |
| Financial instruments         | 5,572            | 4,772            | 3,898            |
| Sale of non-operating assets  | 2,051            |                  | 4,271            |
| Other                         | 4,414            | 4,513            | 4,744            |
| <b>Other operating income</b> | <b>\$ 43,545</b> | <b>\$ 77,012</b> | <b>\$ 39,773</b> |

Loss and loss adjustment expense increased 17% in 2007 and 10% in 2006. Both years increased due to growth in net retained premium. Policy acquisition costs increased 15% in 2007 and 22% in 2006, primarily due to the growth in net earned premium. See the Insurance Company Segment section below for further discussion of the changes in loss and loss adjustment expense and policy acquisition costs.



Other operating expense, which includes compensation expense, increased 9% in 2007 and 23% in 2006. The increase in 2007 is primarily due to inclusion of a full year of operations of the Health Products Division, acquired in the last quarter of 2006, partially offset by lower costs related to our stock option investigation. In addition, 2007 included a \$13.4 million charge to correct the accounting for embedded currency conversion gains on certain fixed income securities classified as available for sale. Since 2005, we used certain available for sale fixed income securities, denominated in British pound sterling, to economically hedge foreign currency exposure on certain insurance reserves and other liabilities, denominated in the same currency. We incorrectly recorded the unrealized exchange rate fluctuations on these securities through earnings as an offset

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to the opposite fluctuations in the liabilities they hedged, rather than through other comprehensive income within shareholders' equity. In 2007, to correct our accounting, we reversed \$13.4 million of cumulative unrealized exchange rate gains. We recorded this reversal as a charge to our gain or loss from currency conversion account, with an offsetting credit to other comprehensive income. We reported our net loss from currency conversion, which included this \$13.4 million charge, as a component of other operating expense in the consolidated statements of earnings. In 2007, we sold these available for sale securities and realized the \$13.4 million of embedded cumulative currency conversion gains. This gain was included in the net realized investment gain (loss) line of our consolidated statements of earnings. The offsetting effect of these transactions had no impact on our 2007 consolidated net earnings. See the discussion above related to realized investment gains. Our 2006 other operating expense increased for stock option expense under Statement of Financial Accounting Standards (SFAS) No. 123(R); higher professional fees, legal costs and other expenses related to our stock option investigation; and operating expenses of subsidiaries acquired in 2006 and the second half of 2005. We had 1,682 employees at December 31, 2007, compared to 1,660 a year earlier.

In 2007 and 2006, we expensed \$11.3 million (\$7.4 million after-tax or \$0.06 per diluted share) and \$13.1 million (\$9.4 million after-tax or \$0.08 per diluted share) of stock-based compensation, after the effect of the deferral and amortization of related policy acquisition costs. Effective January 1, 2006, we adopted SFAS No. 123(R), *Share-Based Payment*, using the modified prospective method. We are recognizing compensation expense for all previously-granted but unvested stock options as of January 1, 2006, and for all options granted after that date. Prior to adoption, we accounted for our stock options in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and recognized compensation expense of \$3.0 million in 2005. The 2005 consolidated financial statements were not restated to reflect our adoption of SFAS 123(R). At December 31, 2007, there was approximately \$28.8 million of total unrecognized compensation expense related to unvested options that is expected to be recognized over a weighted-average period of 3.0 years.

Our effective income tax rate on earnings from continuing operations was 32.5% for 2007, compared to 32.9% for 2006 and 30.9% for 2005. The effective tax rate was lower in 2005 because our tax exempt interest income was a greater percentage of our pre-tax income and we recorded a special \$2.8 million repatriation tax benefit.

At December 31, 2007, book value per share was \$21.21 up from \$18.28 at December 31, 2006 and \$15.26 at December 31, 2005. Total assets were \$8.1 billion and shareholders' equity was \$2.4 billion, up from \$7.6 billion and \$2.0 billion, respectively, at December 31, 2006.

**Table of Contents****Segments**

We operate our businesses in three segments: insurance company, agency and other operations. Our Chief Executive Officer, as chief decision maker, monitors and evaluates the individual financial results of each subsidiary in the insurance company and agency segments. Each subsidiary provides monthly reports of its actual and budgeted results, which are aggregated on a segment basis for management review and monitoring. The operating results of our insurance company, agency, and other operations segments are discussed below.

**Insurance Company Segment**

Net earnings of our insurance company segment increased 32% to \$357.8 million in 2007 compared to \$272.0 million in 2006 and \$126.1 million in 2005. The 2006 net earnings included \$13.1 million of after-tax losses related to a commutation. The 2005 net earnings included \$75.2 million of after-tax losses related to hurricanes and a commutation. The growth in segment net earnings was driven by improved underwriting results, increased investment income, and the operations of acquired subsidiaries. Also, effective April 1, 2006, we consolidated one of our underwriting agencies into one of our insurance companies; all operations after that date were reported in our insurance company segment. Even though there is pricing competition in all of our markets, our margins remain at an acceptable level of profitability due to our underwriting expertise and discipline.

**Premium**

Gross written premium increased 10% in both 2007 and 2006. Net written premium increased 10% to \$2.0 billion and net earned premium increased 16% to \$2.0 billion in 2007 compared to increases of 21% and 25%, respectively, in 2006. The 2007 increases were primarily due to our 2006 acquisition of the Health Products Division and organic growth in our surety, credit and other specialty lines of business. The overall percentage of retained premium remained constant at 81% in 2007 and 2006. The 2006 net premium increase exceeded the gross premium increase due to higher retention levels on most non-catastrophe business.

The following table details premium amounts and their percentages of gross written premium.

|                            | 2007                |            | 2006                |            | 2005                |            |
|----------------------------|---------------------|------------|---------------------|------------|---------------------|------------|
|                            | Amount              | %          | Amount              | %          | Amount              | %          |
| Direct                     | \$ 2,000,552        | 82%        | \$ 1,867,908        | 84%        | \$ 1,768,284        | 87%        |
| Reinsurance assumed        | 450,627             | 18         | 367,740             | 16         | 270,002             | 13         |
| Gross written premium      | 2,451,179           | 100        | 2,235,648           | 100        | 2,038,286           | 100        |
| Reinsurance ceded          | (465,570)           | (19)       | (423,096)           | (19)       | (537,062)           | (26)       |
| Net written premium        | 1,985,609           | 81         | 1,812,552           | 81         | 1,501,224           | 74         |
| Change in unearned premium | (523)               |            | (103,363)           | (5)        | (131,236)           | (7)        |
| <b>Net earned premium</b>  | <b>\$ 1,985,086</b> | <b>81%</b> | <b>\$ 1,709,189</b> | <b>76%</b> | <b>\$ 1,369,988</b> | <b>67%</b> |

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The following tables provide premium information by line of business.

|                                     | <b>Gross<br/>Written<br/>Premium</b> | <b>Net Written<br/>Premium</b> | <b>NWP<br/>as% of<br/>GWP</b> | <b>Net Earned<br/>Premium</b> |
|-------------------------------------|--------------------------------------|--------------------------------|-------------------------------|-------------------------------|
| <u>Year ended December 31, 2007</u> |                                      |                                |                               |                               |
| Diversified financial products      | \$ 963,355                           | \$ 771,648                     | 80%                           | \$ 777,414                    |
| Group life, accident and health     | 798,684                              | 759,207                        | 95                            | 758,516                       |
| Aviation                            | 195,809                              | 145,761                        | 74                            | 153,121                       |
| London market account               | 213,716                              | 118,241                        | 55                            | 124,609                       |
| Other specialty lines               | 280,040                              | 191,151                        | 68                            | 171,824                       |
| Discontinued lines                  | (425)                                | (399)                          | nm                            | (398)                         |
| <b>Totals</b>                       | <b>\$ 2,451,179</b>                  | <b>\$ 1,985,609</b>            | <b>81%</b>                    | <b>\$ 1,985,086</b>           |
| <u>Year ended December 31, 2006</u> |                                      |                                |                               |                               |
| Diversified financial products      | \$ 956,057                           | \$ 794,232                     | 83%                           | \$ 728,861                    |
| Group life, accident and health     | 621,639                              | 590,811                        | 95                            | 591,070                       |
| Aviation                            | 216,208                              | 166,258                        | 77                            | 152,886                       |
| London market account               | 234,868                              | 127,748                        | 54                            | 112,362                       |
| Other specialty lines               | 205,651                              | 133,481                        | 65                            | 123,981                       |
| Discontinued lines                  | 1,225                                | 22                             | nm                            | 29                            |
| <b>Totals</b>                       | <b>\$ 2,235,648</b>                  | <b>\$ 1,812,552</b>            | <b>81%</b>                    | <b>\$ 1,709,189</b>           |
| <u>Year ended December 31, 2005</u> |                                      |                                |                               |                               |
| Diversified financial products      | \$ 908,526                           | \$ 675,942                     | 74%                           | \$ 531,136                    |
| Group life, accident and health     | 593,382                              | 502,805                        | 85                            | 504,382                       |
| Aviation                            | 210,530                              | 130,743                        | 62                            | 136,197                       |
| London market account               | 144,425                              | 78,809                         | 55                            | 93,017                        |
| Other specialty lines               | 176,139                              | 109,106                        | 62                            | 97,721                        |
| Discontinued lines                  | 5,284                                | 3,819                          | nm                            | 7,535                         |
| <b>Totals</b>                       | <b>\$ 2,038,286</b>                  | <b>\$ 1,501,224</b>            | <b>74%</b>                    | <b>\$ 1,369,988</b>           |

nm Not meaningful comparison

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

Diversified financial products The growth in our gross written premium in both years resulted primarily from organic growth in our surety and credit businesses, where pricing is stable and competition is reasonable. This was offset by a decline in our directors and officers liability business, as competition has resulted in less premium being written. Net written premium also declined in 2007 due to additional quota share reinsurance

purchased for our international directors and officers liability insurance. Net earned premium for diversified financial products increased in both years due to the 2006 increase in net written premium.

Group life, accident and health Gross written, net written and net earned premium of our medical stop-loss and medical excess products increased due to the 2006 acquisition of the Health Products Division. We retain all of our medical stop-loss and medical excess business because the business is non-volatile and has very little catastrophe exposure. Profit margins remain at acceptable levels despite competition from the fully-insured market.

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**Aviation** Our domestic aviation business has been stable, while gross written premium of our international business has declined. We have exercised underwriting discipline and written less international business due to competition and the resultant pressure on pricing. However, margins on decreased premium volume are still acceptable. Net written premium increased \$12.5 million in 2006 due to a portfolio transfer of in-force premium to a new reinsurance program with a higher retention and decreased \$2.5 million in 2007 due to a portfolio transfer with a lower retention.

**London market account** Net written premium decreased slightly in 2007 due to competition increasing in this line of business. This followed a large increase in energy writings in 2006 that resulted from significantly increased rates after the 2005 hurricanes. We reduced our aggregate property exposure in Florida and other hurricane-exposed onshore areas in 2006, and we maintained the reduced exposure in 2007. Additionally, due to the tightening of policy terms and conditions, our energy catastrophe exposure was significantly reduced in 2006, even though our business increased, and continued at this reduced level in 2007. Net earned premium increased in both years due to the amount of energy business written in 2006.

**Other specialty lines** We experienced growth in our other specialty lines of business from expansion of our Lloyd's of London syndicate participation, increased writings in several products, and a 2006 acquisition. The changing mix of products affected the retention percentages. Markets for these products are competitive and rates are down slightly.

## ***Reinsurance***

Annually, we analyze our threshold for risk in each line of business and on an overall consolidated basis, based on a number of factors, including market conditions, pricing, competition and the inherent risks associated with each business type, and then we structure a reinsurance program. Based on our analysis of these factors, we may determine not to purchase reinsurance for some lines of business. We generally purchase reinsurance to reduce our net liability on individual risks and to protect against catastrophe losses and volatility. We purchase reinsurance on a proportional basis to cover loss frequency, individual risk severity and catastrophe exposure. Some of the proportional reinsurance agreements may have maximum loss limits, most of which are at or greater than a 200% loss ratio. We also purchase reinsurance on an excess of loss basis to cover individual risk severity and catastrophe exposure. Additionally, we may obtain facultative reinsurance protection on a single risk. The type and amount of reinsurance we purchase varies year to year based on our risk assessment, our desired retention levels based on profitability and other considerations, and the market availability of quality reinsurance at prices we consider acceptable. Our reinsurance programs renew throughout the year and the price changes in recent years have not been material to our net underwriting results. Our reinsurance generally does not cover war or terrorism risks, which are excluded from most of our policies.

We decided for the 2006 and 2005 underwriting years to retain more underwriting risk in certain lines of business in order to retain a greater proportion of expected underwriting profits. In doing so, we purchased less reinsurance and converted some reinsurance from proportional to excess of loss, which significantly reduced the amount of ceded premium in 2006. Ceded premium as a percentage of gross written premium remained constant at 19% in 2007 compared to 2006. We have chosen not to purchase any reinsurance on business where volatility or catastrophe risks are considered remote.

In our proportional reinsurance programs, we generally receive an overriding (ceding) commission on the premium ceded to reinsurers. This compensates our insurance companies for the direct costs associated with production of the business, the servicing of the business during the term of the policies ceded, and the costs associated with placement of the related reinsurance. In addition, certain of our reinsurance treaties allow us to share in any net profits generated under such treaties with the reinsurers. Various reinsurance brokers, including subsidiaries, arrange for the placement

of this proportional and other reinsurance coverage on our behalf and are compensated, directly or indirectly, by the reinsurers.

Our reinsurance recoverables decreased in amount and as a percentage of our shareholders' equity in 2007 and 2006, as we reinsured less business, especially on a proportional basis, and as the 2005 hurricane

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losses were paid and we collected amounts due from our reinsurers for their part of these paid losses. Our Reinsurance Security Committee carefully monitors the credit quality of the reinsurers we do business with on a current basis. Our recoverables are due principally from highly-rated reinsurers.

We have a reserve of \$8.5 million at December 31, 2007 for potential collectibility issues related to reinsurance recoverables, including disputed amounts and associated expenses. While we believe the reserve is adequate based on information currently available, conditions may change or additional information might be obtained that may require us to change the reserve in the future. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

**Losses and Loss Adjustment Expenses**

The table below shows the composition of gross incurred loss and loss adjustment expense.

|   | 2007                |              | 2006                |              | 2005                |              |
|---|---------------------|--------------|---------------------|--------------|---------------------|--------------|
|   | Amount              | Loss Ratio   | Amount              | Loss Ratio   | Amount              | Loss Ratio   |
| 2005 hurricanes   | \$                  | %            | \$ 12,670           | 0.6%         | \$ 394,625          | 19.9%        |
| 2004 hurricanes   |                     |              | (2,984)             | (0.2)        | (13,423)            | (0.7)        |
| Discontinued accident and health adjustments              | (46,531)            | (1.9)        | 15,054              | 0.7          | 49,775              | 2.5          |
| Discontinued medical malpractice adjustments              | 11,568              | 0.5          | 2,353               | 0.1          | 821                 |              |
| Other reserve redundancies                                | (55,658)            | (2.3)        | (30,394)            | (1.4)        | (7,901)             | (0.4)        |
| All other gross incurred loss and loss adjustment expense | 1,443,031           | 59.2         | 1,222,139           | 56.9         | 1,172,876           | 59.0         |
| <b>Gross incurred loss and loss expense adjustment</b>    | <b>\$ 1,352,410</b> | <b>55.5%</b> | <b>\$ 1,218,838</b> | <b>56.7%</b> | <b>\$ 1,596,773</b> | <b>80.3%</b> |

Our gross redundant (adverse) reserve development relating to prior years' losses was \$90.6 million in 2007, \$3.3 million in 2006, and \$(29.3) million in 2005.

The gross losses related to prior accident years on certain run-off assumed accident and health reinsurance business reported in our discontinued lines of business have fluctuated due to our processing of additional information received and our continuing evaluation of gross and net reserves related to this business. We considered a combination of factors including: 1) the nature of the business, which is primarily excess of loss reinsurance, 2) late reported losses by insureds, reinsureds and state guaranty associations and 3) changes in our actuarial assumptions to reflect additional information received during the year. The run-off assumed accident and health reinsurance business is primarily reinsurance that provides excess coverage for large losses related to workers' compensation policies. This business is slow to develop and may take as many as twenty years to pay out. Losses in lower layers must develop first before our excess coverage attaches. Thus, the losses are reported to excess of loss reinsurers later in the life cycle of the claim. Compounding this late reporting is the fact that a number of large insurance companies that were cedants of this business failed and were taken over by state regulatory authorities in 2002 and 2003. The state guaranty associations



covering these failed companies have been slow to report losses to us. Based on the higher amount of actual losses reported, we revised the expected loss ratios used in our actuarial calculations, particularly in 2005. After consideration of all currently available information, we adjusted our gross and net reserves each year to amounts that management determined were appropriate to cover projected losses, given the risk inherent in this type of business. Because of substantial reinsurance, the net effects of these adjustments on our consolidated net earnings have been much less than the gross effects shown above.

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The other gross reserve redundancies resulted primarily from our review and reduction of reserves where the anticipated development was considered to be less than the recorded reserves. Deficiencies and redundancies also occur as a result of claims being settled for amounts different from recorded reserves, or as claims exposures change. Loss reserves on international medical malpractice business, in run-off since we acquired the subsidiary that wrote this business in 2002, were strengthened in 2007 in response to a deteriorating legal and settlement environment. The other gross reserve redundancies in 2007 related primarily to reserve reductions in our diversified financial products line of business from the 2003 and 2004 underwriting years. The other gross reserve redundancies in 2006 related primarily to a reduction in aviation reserves from the 2004 and 2005 accident years.

The table below shows the composition of net incurred loss and loss adjustment expense.

|   | 2007                |              | 2006                |              | 2005              |              |
|---|---------------------|--------------|---------------------|--------------|-------------------|--------------|
|   | Amount              | Loss Ratio   | Amount              | Loss Ratio   | Amount            | Loss Ratio   |
| 2005 hurricanes   | \$                  | %            | \$ (15,215)         | (0.9)%       | \$ 73,185         | 5.3%         |
| 2004 hurricanes   |                     |              | (2,483)             | (0.2)        | (7,167)           | (0.5)        |
| Discontinued accident and health commutations           | 2,616               | 0.1          | 20,199              | 1.2          | 26,041            | 1.9          |
| Discontinued accident and health adjustments            | 376                 |              | 4,898               | 0.3          | 8,929             | 0.7          |
| Discontinued medical malpractice adjustments            | 11,568              | 0.6          | 2,738               | 0.2          | 856               |              |
| Other reserve redundancies                              | (40,957)            | (2.1)        | (16,663)            | (1.0)        | (3,265)           | (0.2)        |
| All other net incurred loss and loss adjustment expense | 1,210,344           | 61.0         | 1,018,382           | 59.6         | 821,118           | 59.9         |
| <b>Net incurred loss and loss adjustment expense</b>    | <b>\$ 1,183,947</b> | <b>59.6%</b> | <b>\$ 1,011,856</b> | <b>59.2%</b> | <b>\$ 919,697</b> | <b>67.1%</b> |

Our net redundant (adverse) reserve development relating to prior years' losses was \$26.4 million in 2007, \$6.5 million in 2006, and \$(25.4) million in 2005, including amounts due to commutations that affected our discontinued line of business. The commutation losses primarily represent the discount for the time value of money on the reinsurance recoverables commuted. The discontinued accident and health business was substantially reinsured; therefore, the impact on our net earnings was substantially less than the amount of the gross losses. Loss reserves on international medical malpractice business, in run-off since we acquired the subsidiary that wrote this business in 2002, were strengthened in 2007 in response to a deteriorating legal and settlement environment. These losses were not reinsured. We reduced our net loss reserves on prior years' hurricanes in 2006 and 2005 to reflect current estimates of our remaining liabilities. The other net reserve redundancies in 2007 related primarily to reserve reductions in our diversified financial products line of business from the 2003 and 2004 underwriting years. The other net reserve redundancies in 2006 related primarily to a reduction in aviation reserves from the 2004 and 2005 accident years. A portion of these reserves were reinsured. We have no material exposure to environmental or asbestos losses and believe we have provided for all material net incurred losses.

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The following table provides comparative net loss ratios by line of business.

|                                 | 2007                     |                      | 2006                     |                      | 2005                     |                      |
|---------------------------------|--------------------------|----------------------|--------------------------|----------------------|--------------------------|----------------------|
|                                 | Net<br>Earned<br>Premium | Net<br>Loss<br>Ratio | Net<br>Earned<br>Premium | Net<br>Loss<br>Ratio | Net<br>Earned<br>Premium | Net<br>Loss<br>Ratio |
| Diversified financial products  | \$ 777,414               | 40.6%                | \$ 728,861               | 48.2%                | \$ 531,136               | 48.1%                |
| Group life, accident and health | 758,516                  | 76.4                 | 591,070                  | 73.1                 | 504,382                  | 71.6                 |
| Aviation                        | 153,121                  | 58.6                 | 152,886                  | 53.8                 | 136,197                  | 67.3                 |
| London market account           | 124,609                  | 55.2                 | 112,362                  | 43.0                 | 93,017                   | 106.0                |
| Other specialty lines           | 171,824                  | 67.4                 | 123,981                  | 56.0                 | 97,721                   | 72.6                 |
| Discontinued lines              | (398)                    | nm                   | 29                       | nm                   | 7,535                    | nm                   |
| <b>Totals</b>                   | <b>\$ 1,985,086</b>      | <b>59.6%</b>         | <b>\$ 1,709,189</b>      | <b>59.2%</b>         | <b>\$ 1,369,988</b>      | <b>67.1%</b>         |
| <b>Expense ratio</b>            |                          | 23.8                 |                          | 25.0                 |                          | 26.1                 |
| <b>Combined ratio</b>           |                          | 83.4%                |                          | 84.2%                |                          | 93.2%                |

nm Not meaningful comparison

The change in net loss ratios by line of business between years resulted principally from the following factors:

**Diversified financial products** The decrease in the 2007 loss ratio was due to better underwriting results for certain business written in 2006 and earned in 2007, compared to business written in 2005 and earned in 2006, and favorable loss development on our directors and officers and international professional indemnity businesses, primarily on our 2003 and 2004 underwriting years. Additionally, our surety and credit businesses, which have lower loss ratios than other businesses in this line, are growing and reducing the overall loss ratio. Our domestic surety business also had favorable loss development during 2007.

**Group life, accident and health** The net loss ratio was higher on business acquired with the Health Products Division in 2006. Over time, as the acquired business is re-underwritten, we expect the loss ratio will decline. The net loss ratio was also higher than expected as more of our business is being written on a net of commission basis. While the net business increased our loss ratio (since the denominator is lower), it reduced our expense ratio such that our combined ratio and margin for this business remain relatively stable.

**Aviation** The 2005 hurricanes increased the net loss ratio by 5.0 percentage points in 2005. The 2005 net loss ratio also included a favorable impact from the release of redundant reserves related to 2004 hurricanes. Excluding the impact of the hurricanes, 2005 had worse than expected underwriting experience due to some unusually large international losses, while 2006 underwriting results were better than expected, due in part to the release of redundant reserves on the 2004 and 2005 accident years.

**London market account** The loss ratio in 2007 was slightly higher than expected due to adverse development in our London accident and health and energy businesses. The 2005 hurricanes increased the 2005 net loss ratio by 63.2 percentage points. Subsequent reduction of these reserves reduced the 2006 net loss ratio by

9.1 percentage points. The 2006 net loss ratio was also affected by higher than expected attritional losses for energy losses and poor underwriting results on marine business. The London market account line of business can have relatively high year-to-year volatility due to catastrophe exposure.

Other specialty lines The 2005 hurricanes increased the 2005 net loss ratio by 14.0 percentage points. Subsequent reduction of these reserves reduced the 2006 net loss ratio by 3.9 percentage points. The increase in the 2007 net loss ratio related to losses in our marine and United Kingdom liability lines of business.

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Discontinued lines All years were adversely affected by the commutations and net loss reserve adjustments discussed previously. In addition, loss reserves on our international medical malpractice business, in run-off since we acquired the subsidiary that wrote this business in 2002, were strengthened in 2007 in response to a deteriorating legal and settlement environment.

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

|   | <b>2007</b>         | <b>2006</b>         | <b>2005</b>         |
|---|---------------------|---------------------|---------------------|
| Reserves for loss and loss adjustment expense payable at beginning of year  | \$ 2,108,961        | \$ 1,533,433        | \$ 1,059,283        |
| Reserve additions from acquired businesses                                  | 742                 | 146,811             | 12,491              |
| Incurred loss and loss adjustment expense                                   | 1,183,947           | 1,011,856           | 919,697             |
| Loss and loss adjustment expense payments                                   | (950,850)           | (583,139)           | (458,038)           |
| <b>Reserves for loss and loss adjustment expense payable at end of year</b> | <b>\$ 2,342,800</b> | <b>\$ 2,108,961</b> | <b>\$ 1,533,433</b> |
| <b>Net paid loss ratio</b>  | <b>47.9%</b>        | <b>34.1%</b>        | <b>33.4%</b>        |

The net paid loss ratio is the percentage of losses paid, net of reinsurance, divided by net earned premium for that year. The increase in loss and loss adjustment expense payments in 2007 was due to payment of claims related to the Health Products Division business acquired in 2006 and the 2005 hurricanes. Payments in 2006 and 2005 were reduced \$100.0 million and \$119.7 million, respectively, due to the discontinued accident and health commutations recorded in those years. The commutations decreased our net paid loss ratios by 5.9 and 8.7 percentage points in 2006 and 2005, respectively.

***Policy Acquisition Costs***

Policy acquisition costs, which are net of the related portion of commissions on reinsurance ceded, increased to \$366.6 million in 2007 from \$319.9 million in 2006 and \$261.7 million in 2005. Policy acquisition costs as a percentage of net earned premium decreased to 18.5% in 2007 from 18.7% in 2006 and 19.1% in 2005. The decreases are due to a change in the mix of business and reductions in commission rates on certain lines of business. The GAAP expense ratio of 23.8% in 2007 decreased in comparison to 25.0% in 2006 and 26.1% in 2005 for the same reasons and, in addition, net earned premium increased at a higher rate than the expenses that are used to calculate the expense ratio.

***Statutory***

Regulatory guidelines suggest that a property and casualty insurer's annual statutory gross written premium should not exceed 900% of its statutory policyholders' surplus and net written premium should not exceed 300% of its statutory policyholders' surplus. However, industry and rating agency guidelines place these ratios at 300% and 200%, respectively. Our property and casualty insurance companies have maintained premium to surplus ratios lower than such guidelines. For 2007, our statutory gross written premium to policyholders' surplus was 141.0% and our statutory net written premium to policyholders' surplus was 113.8%. At December 31, 2007, each of our domestic insurance

companies' total adjusted capital was significantly in excess of the authorized control level risk-based capital level prescribed by the National Association of Insurance Commissioners.

*Agency Segment*

Revenue from our agency segment decreased to \$178.6 million in 2007 from \$180.0 million in 2006 and \$188.9 million in 2005, primarily due to the consolidation of one of our underwriting agencies into one of our insurance companies effective April 1, 2006, less business being produced in certain lines of business, and the overall effect of ceding less reinsurance. These effects were partially offset by 2006 acquisitions and growth in certain other lines of business. While the consolidation and increased retentions resulted in less fee and

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commission income to our agency segment, they resulted in increased insurance company revenue and net earnings. Segment earnings decreased to \$33.9 million in 2007 from \$42.3 million in 2006 due to the lower revenue, change in the mix of business that resulted in lower pre-tax margin, a higher income tax rate, and increased corporate cost allocations. Segment net earnings were \$38.5 million in 2005 and would have decreased in 2006, except the agency segment benefited from lower corporate cost allocations.

***Other Operations Segment***

Revenue and net earnings from our other operations segment decreased to \$38.9 million and \$22.8 million, respectively, in 2007 from \$75.1 million and \$48.8 million, respectively, in 2006, primarily as a result of less income from trading securities and the sale of strategic investments. The 2006 amounts increased from \$35.3 million and \$22.6 million, respectively, in 2005 due to increased income from trading securities and the sale of strategic investments. In the fourth quarter of 2006, we began liquidating our trading portfolio, which we substantially completed in the first quarter of 2007 with the exception of two insurance-related securities, and invested the proceeds in fixed income securities. Results of this segment may vary substantially period to period depending on our investment in or disposition of strategic investments and activity in our trading portfolio.

**Liquidity and Capital Resources*****Cash Flow***

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

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

Our increasing net earnings,

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

Commutations of selected reinsurance agreements, and

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

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

|   | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|---|-------------|-------------|-------------|
| Net earnings  | \$ 395,429  | \$ 342,285  | \$ 191,192  |
| Change in premium, claims and other receivables, net of reinsurance, other payables and restricted cash | (60,671)    | (139,906)   | (59,717)    |
| Change in unearned premium, net   | 3,062       | 122,571     | 121,242     |

|   |                   |                   |                   |
|---|-------------------|-------------------|-------------------|
| Change in loss and loss adjustment expense payable, net of reinsurance recoverables | 342,556           | 328,569           | 454,859           |
| Change in trading portfolio   | 9,362             | (19,919)          | (66,809)          |
| Other, net  | 36,698            | 19,788            | (16,777)          |
| <b>Cash provided by operating activities</b>  | <b>\$ 726,436</b> | <b>\$ 653,388</b> | <b>\$ 623,990</b> |

Cash provided by operating activities increased \$73.0 million in 2007 and \$29.4 million in 2006. Cash received from commutations, included in cash provided by operating activities, totaled \$101.0 million, \$12.8 million and \$180.8 million in 2007, 2006 and 2005, respectively. Excluding the commutations, cash



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provided by operating activities decreased \$15.2 million in 2007 and increased \$197.4 million in 2006. The decrease in 2007 resulted principally from reductions of our loss and loss adjustment expense payable balances, partially offset by an increase in net earnings. The increase in 2006 was primarily due to the increase in net earnings and activity in our trading portfolio.

**Investments**

At December 31, 2007, we had \$4.7 billion of investment assets, an increase of \$744.3 million from the end of 2006. The increase resulted from strong operating cash flows. The majority of our investment assets are held by our insurance companies. We held \$3.7 billion of fixed income securities, all of which are classified as available for sale and recorded at market value. The fair value of these fixed income securities and the related investment income fluctuate depending on general economic and market conditions, including the recent downturn in the market due to subprime issues. In 2007 and continuing into 2008, the credit markets have been severely affected by various events. Although this has affected interest rates and caused other companies to record large write-downs of their investments, we have had no realized impairment losses on our fixed income securities.

Our investment policy is determined by our Board of Directors and our Investment and Finance Committee and is reviewed on a regular basis. Our policy for each of our insurance company subsidiaries must comply with applicable state and Federal regulations which prescribe the type, quality and concentration of investments. These regulations permit investments, within specified limits and subject to certain qualifications, in federal, state and municipal obligations, obligations of foreign countries, corporate bonds and preferred and common equity securities. The regulations generally allow certain other types of investments subject to maximum limitations.

We engage independent investment advisors to oversee our fixed income investments and to make investment recommendations. We invest our funds principally in highly-rated fixed income securities. Our historical investment strategy is to maximize interest income and yield, rather than to maximize total return. In accordance with our strategy, realized gains and losses from sales of investment securities are usually minimal, unless we decide to capture gains to enhance statutory capital and surplus of our insurance company subsidiaries. Although we generally intend to hold fixed income securities to maturity, we regularly re-evaluate our position based on market conditions. Our portfolio turnover will fluctuate, depending upon opportunities to increase yields by replacing one security with another higher yielding security.

At December 31, 2007, we had cash and short-term investments of \$822.8 million, of which \$586.9 million was held by our insurance companies. We maintain cash and liquid short-term instruments in our insurance companies in order to be able to fund losses of our insureds. Cash and short-term investments were higher than normal at December 31, 2007 due to proceeds from the sale of fixed income securities that hedged certain foreign currency denominated liabilities and, at December 31, 2006, due to proceeds from the liquidation of our trading portfolio.

This table shows a profile of our fixed income and short-term investments. The table shows the average amount of investments, income earned and the yield thereon.

|   | <b>2007</b>  | <b>2006</b>  | <b>2005</b>  |
|---|--------------|--------------|--------------|
| Average investments, at cost            | \$ 4,214,798 | \$ 3,529,671 | \$ 2,822,686 |
| Net investment income*                  | 206,462      | 152,804      | 98,851       |
| Average short-term yield*               | 5.2%         | 4.5%         | 2.7%         |
| Average long-term yield*                | 4.5%         | 4.4%         | 4.0%         |
| Average long-term tax equivalent yield* | 5.4%         | 5.2%         | 4.9%         |

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|   |           |           |           |
|---|-----------|-----------|-----------|
| Weighted average combined tax equivalent yield* | 5.6%      | 5.0%      | 4.1%      |
| Weighted average maturity                       | 7.0 years | 6.9 years | 7.6 years |
| Weighted average duration                       | 4.9 years | 4.6 years | 4.9 years |
| Average S&P rating                              | AAA       | AAA       | AAA       |

\* Excluding realized and unrealized investment gains and losses.

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This table summarizes our investments by type, substantially all of which are reported at fair value, at December 31, 2007.

|   | <b>Amount</b>       | <b>%</b>    |
|---|---------------------|-------------|
| Short-term investments                            | \$ 783,650          | 17%         |
| U.S. government                                   | 163,583             | 4           |
| States, municipalities and political subdivisions | 724,305             | 16          |
| Special revenue fixed income securities           | 1,097,976           | 23          |
| Corporate fixed income securities                 | 297,568             | 6           |
| Asset-backed and mortgage-backed securities       | 1,009,692           | 22          |
| Foreign securities                                | 373,581             | 8           |
| Other investments                                 | 221,922             | 4           |
| <b>Total investments</b>                          | <b>\$ 4,672,277</b> | <b>100%</b> |

At December 31, 2007, we held subprime-related securities with a fair value of \$17.8 million, which represented 1.8% of our asset-backed and mortgage-backed securities portfolio and 0.5% of our total fixed income securities portfolio. Our subprime-related securities had a total unrealized loss of \$0.6 million at December 31, 2007, and none had an other-than-temporary impairment. The average rating on these bonds was AAA, and all bonds were current as to principal and interest. We had no realized losses from sales of our subprime-related securities during 2007 or through February 15, 2008. We owned no collateralized debt obligations, collateralized loan obligations or auction rate securities at December 31, 2007.

This table summarizes, by rating, the fair value of our investments in fixed income securities at December 31, 2007.

|                                      | <b>Amount</b>       | <b>%</b>    |
|--------------------------------------|---------------------|-------------|
| AAA                                  | \$ 2,971,589        | 81%         |
| AA                                   | 420,842             | 11          |
| A                                    | 243,774             | 7           |
| BBB                                  | 30,107              | 1           |
| BB and below                         | 393                 |             |
| <b>Total fixed income securities</b> | <b>\$ 3,666,705</b> | <b>100%</b> |

This table indicates the expected maturity distribution of the fair value of our fixed income securities at December 31, 2007.

|                        | <b>Amount</b> | <b>%</b> |
|------------------------|---------------|----------|
| One year or less       | \$ 179,763    | 5%       |
| One year to five years | 759,231       | 21       |

|   |                     |             |
|---|---------------------|-------------|
| Five years to ten years                     | 682,303             | 19          |
| Ten years to fifteen years                  | 502,752             | 14          |
| More than fifteen years                     | 532,964             | 14          |
| Securities with fixed maturities            | 2,657,013           | 73          |
| Asset-backed and mortgage-backed securities | 1,009,692           | 27          |
| <b>Total fixed income securities</b>        | <b>\$ 3,666,705</b> | <b>100%</b> |

The weighted average life of our asset-backed and mortgage-backed securities is 5.6 years.

The fair value of our fixed income securities is sensitive to changing interest rates. As interest rates increase, the fair value will generally decrease and as rates decrease, the fair value will generally increase. The fluctuations in fair value are somewhat muted by the relatively short duration of our portfolio and our

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relatively high level of investments in state and municipal obligations. During 2007, the net pre-tax unrealized gain on our fixed income securities increased \$26.7 million due to market value changes resulting from interest rate changes. We estimate that a 1% increase (e.g. from 5% to 6%) in market interest rates would decrease the fair value of our fixed income securities by approximately \$179.7 million and a 1% decrease in market interest rates would increase the fair value by a like amount. Fluctuations in interest rates have a minimal effect on the value of our short-term investments due to their very short maturities. In our current position, higher interest rates would have a positive effect on net earnings.

Some of our fixed income securities have call or prepayment options. In addition, mortgage-backed and certain asset-backed securities have prepayment or other market-related credit risk. Prepayment risk exists if the timing of cash flows that result from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. Credit risk exists if mortgagees default on the underlying mortgages. Net investment income and/or cash flows from investments that carry call or prepayment options and prepayment or credit risk may differ from those anticipated at the time of investment. Calls and prepayments subject us to reinvestment risk should interest rates fall or issuers call their securities and we reinvest the proceeds at lower interest rates. For asset-backed and mortgage-backed securities, prepayment or credit risk could reduce the yield or the return of the remaining principal of these securities. We mitigate this risk by investing in investment grade securities with varied maturity dates, so that only a portion of our portfolio will mature at any point in time.

The average duration of claims in many of our lines of business is relatively short and, accordingly, our investment portfolio has a relatively short duration. In recent years, we have expanded the directors' and officers' liability and professional indemnity components of our diversified financial products line of business, which have a longer claims duration than our other lines of business. We are taking these changes into consideration in determining the duration of our investment portfolio.

The following table compares our insurance company subsidiaries' cash and investment maturities with their estimated future claims payments at December 31, 2007.

|   | <b>Total</b>        | <b>Maturities/Estimated Payment Dates</b> |                     |                   |                     |
|---|---------------------|---|---------------------|-------------------|---------------------|
|   |                     | <b>2008</b>                               | <b>2009-2010</b>    | <b>2011-2012</b>  | <b>Thereafter</b>   |
| Cash and investment maturities of insurance companies                   | \$ 4,463,560        | \$ 978,950                                | \$ 610,523          | \$ 556,154        | \$ 2,317,933        |
| Estimated loss and loss adjustment expense payments, net of reinsurance | 2,342,800           | 839,689                                   | 769,576             | 368,712           | 364,823             |
| <b>Estimated available cash flow</b>                                    | <b>\$ 2,120,760</b> | <b>\$ 139,261</b>                         | <b>\$ (159,053)</b> | <b>\$ 187,442</b> | <b>\$ 1,953,110</b> |

We maintain sufficient liquidity from our current cash and investment maturities, in combination with future operating cash flow, to pay anticipated policyholder claims on their expected payment dates. We manage the liquidity of our insurance company subsidiaries such that each subsidiary's anticipated claims payments will be met by its own current operating cash flows, cash, short-term investments or investment maturities. We do not foresee the need to sell securities prior to their maturity to fund claims payments, nor do we anticipate needing to use our \$575.0 million Revolving Loan Facility to pay claims. However, this credit facility can provide additional short-term liquidity if an unexpected event were to occur.



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The following table presents a summary of our total contractual cash payment obligations by estimated payment date at December 31, 2007.

|   | <b>Total</b>        | <b>2008</b>         | <b>Estimated Payment Dates</b> |                   | <b>Thereafter</b> |
|---|---------------------|---------------------|--------------------------------|-------------------|-------------------|
|   |                     |                     | <b>2009-2010</b>               | <b>2011-2012</b>  |                   |
| Gross loss and loss adjustment expense payable(1)     |                     |                     |                                |                   |                   |
| Diversified financial products                        | \$ 1,486,047        | \$ 384,260          | \$ 607,690                     | \$ 322,950        | \$ 171,147        |
| Group life, accident and health                       | 351,883             | 292,305             | 48,522                         | 8,530             | 2,526             |
| Aviation  | 169,754             | 76,890              | 60,030                         | 19,361            | 13,473            |
| London market account                                 | 377,316             | 164,019             | 150,484                        | 51,425            | 11,388            |
| Other specialty lines                                 | 342,810             | 115,053             | 139,199                        | 57,108            | 31,450            |
| Discontinued lines                                    | 499,270             | 101,142             | 112,364                        | 59,539            | 226,225           |
| <b>Total loss and loss adjustment expense payable</b> | <b>3,227,080</b>    | <b>1,133,669</b>    | <b>1,118,289</b>               | <b>518,913</b>    | <b>456,209</b>    |
| Life and annuity policy benefits                      | 66,199              | 2,350               | 4,451                          | 4,138             | 55,260            |
| 1.30% Convertible Notes(2)                            | 127,146             | 1,621               | 125,525                        |                   |                   |
| \$575.0 million Revolving Loan Facility(3)            | 237,841             | 9,200               | 18,941                         | 209,700           |                   |
| Operating leases                                      | 73,715              | 12,499              | 22,967                         | 15,853            | 22,396            |
| Earnout liabilities                                   | 31,713              | 29,028              | 2,685                          |                   |                   |
| Indemnifications                                      | 26,698              | 6,473               | 10,852                         | 6,248             | 3,125             |
| <b>Total obligations</b>                              | <b>\$ 3,790,392</b> | <b>\$ 1,194,840</b> | <b>\$ 1,303,710</b>            | <b>\$ 754,852</b> | <b>\$ 536,990</b> |

In preparing the previous table, we made the following estimates and assumptions.

- (1) The estimated loss and loss adjustment expense payments for future periods assume that the percentage of ultimate losses paid from one period to the next will be relatively consistent over time. Actual payments will be influenced by many factors and could vary from the estimated amounts above.
- (2) The 1.30% Convertible Notes mature in 2023, but are shown in the 2009 - 2010 column since the holders may require us to repurchase the Notes on April 1, 2009. The Notes have various put and redemption dates as disclosed in Note 6 to the Consolidated Financial Statements. Amounts include interest payable in respective periods.
- (3) The \$575.0 million Revolving Loan Facility expires on December 19, 2011. Interest on \$200.0 million of the facility is included at an effective fixed rate of 4.6% through November 2009 due to interest rate swaps. Interest on the remaining facility is included at LIBOR plus 25 basis points (4.85% at December 31, 2007).

Our acquisition of HCC Global Financial Products, LLC (HCC Global) included a contingency for earnout payments based on earnings after the acquisition date, as defined in the purchase agreement. When the conditions for accrual

have been satisfied under the applicable purchase agreement, we record a liability to the former owners with an offsetting increase to goodwill. Accrued amounts are generally paid in the next year. At December 31, 2007, we accrued earnout payments totaling \$31.7 million related to this acquisition. The purchase agreement for HCC Global requires us to pay an earnout based on pre-tax earnings on business underwritten by HCC Global from the acquisition date through September 30, 2007, with no maximum amount due to the former owners. The contractual pre-tax earnings include underwriting results on longer-duration business written by HCC Global and, per the agreement, the earnout cannot be finally determined until all future losses are paid.

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



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to perform under the sales contracts. Other indemnifications agree to reimburse the purchasers for taxes or ERISA-related amounts, if any, assessed after the sale date but related to pre-sale activities. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires on December 31, 2009.

We accrue a loss related to our indemnifications when a valid claim is made by a buyer and we believe we have potential exposure. We currently have several claims under indemnifications that cover certain net losses alleged to have been incurred in periods prior to our sale of certain subsidiaries or otherwise alleged to be covered under indemnification agreements related to such sales. As of December 31, 2007, we have recorded a liability of \$14.8 million and have provided \$5.2 million of letters of credit to cover our obligations or anticipated payments under these indemnifications.

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

### ***Subsidiary Dividends***

The principal assets of HCC are the shares of capital stock of its insurance company subsidiaries. Historically, we have not relied on dividends from our insurance companies to meet the parent holding company's obligations, which are primarily outstanding debt and debt service obligations, dividends to shareholders and corporate expenses, since we have had sufficient cash flow from our agencies and reinsurance brokers to meet our corporate cash flow requirements. However, as more profit is now expected to be earned in our insurance companies, we may have to partially depend on cash flow from our insurance companies in the future.

The payment of dividends by our insurance companies is subject to regulatory restrictions and will depend on the surplus and future earnings of these subsidiaries. HCC's direct domestic insurance company subsidiaries can pay an aggregate of \$160.8 million in dividends in 2008 without obtaining special permission from state regulatory authorities. In 2007, 2006 and 2005, our insurance company subsidiaries paid HCC dividends of \$22.6 million, \$44.0 million and \$50.0 million, respectively. The 2005 dividends were then contributed to another insurance company subsidiary.

### ***Lines of Credit***

Our \$575.0 million Revolving Loan Facility allows us to borrow up to the maximum allowed by the facility on a revolving basis until the facility expires on December 19, 2011. At our option, subject to the lenders' ability to obtain the necessary commitments, the amount available under the facility may be increased to \$700.0 million. The interest rate is LIBOR plus a margin of 15 to 50 basis points, depending on our debt rating. The facility is collateralized by guarantees entered into by our domestic underwriting agencies and reinsurance brokers. The facility agreement contains certain restrictive covenants, which we believe are typical for similar financing arrangements. We had \$200.0 million outstanding at December 31, 2007, which we borrowed in 2007 to fund conversion of our 2.00% Convertible Exchange Notes. At December 31, 2007, the contractual interest rate on the outstanding balance was

LIBOR plus 25 basis points (4.85%), but the effective interest rate was 4.6% due to the fixed interest rate swaps discussed below.

In 2007, we entered into three interest rate swap agreements to exchange LIBOR (4.6% at December 31, 2007) for a 4.6% fixed rate on the \$200.0 million outstanding balance of our Revolving Loan Facility. The swaps mature in November 2009 and qualify for cash flow hedge accounting treatment.

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In 2007, we increased our Standby Letter of Credit Facility from \$34.0 million to \$52.0 million with an increase to \$82.0 million in 2008. This facility was entered into in 2006 to replace a portion of our funds at Lloyd's of London with standby letters of credit to guarantee our performance in two Lloyd's of London syndicates. Letters of credit issued under the Standby Letter of Credit Facility are unsecured commitments of HCC. The Standby Letter of Credit Facility contains standard restrictive covenants similar to our Revolving Loan Facility.

At December 31, 2007, certain of our subsidiaries maintained revolving lines of credit with a bank in the combined maximum amount of \$43.3 million available through November 30, 2009. Advances under the lines of credit are limited to amounts required to fund draws, if any, on letters of credit issued by the bank on behalf of the subsidiaries and short-term direct cash advances. The lines of credit are collateralized by securities having an aggregate market value of up to \$54.1 million, the actual amount of collateral at any one time being 125% of the aggregate amount outstanding. Interest on the lines is payable at the bank's prime rate of interest (7.25% at December 31, 2007) for draws on the letters of credit and either prime or prime less 1% on short-term cash advances. At December 31, 2007, letters of credit totaling \$20.5 million had been issued to insurance companies by the bank on behalf of our subsidiaries, with total securities of \$25.6 million collateralizing the lines.

### ***Other***

Our debt to total capital ratio was 11.7% at December 31, 2007 and 13.1% at December 31, 2006.

In 2006, we filed a Universal Shelf registration statement with the SEC, which replaced our previously filed shelf registration and provides for the issuance of an aggregate of \$1.0 billion of our securities. These securities may be debt securities, equity securities, trust preferred securities, or a combination thereof. We sold 4.7 million shares of our common stock at \$32.05 per share in 2005 under our previous shelf registration. Net proceeds of \$150.0 million in 2005 were used to make \$108.0 million of capital contributions to our insurance company subsidiaries and to fund acquisitions.

We believe that our operating cash flows, investments, Revolving Loan Facility, Standby Letter of Credit Facility, shelf registration and other sources of liquidity are sufficient to meet our operating needs for the foreseeable future.

### **Impact of Inflation**

Our operations, like those of other property and casualty insurers, are susceptible to the effects of inflation because premiums are established before the ultimate amounts of loss and loss adjustment expense are known. Although we consider the potential effects of inflation when setting premium rates, our premiums, for competitive reasons, may not fully offset the effects of inflation. However, because the majority of our business is comprised of lines that have relatively short lead times between the occurrence of an insured event, reporting of the claims to us and the final settlement of the claims, or have claims that are not significantly impacted by inflation, the effects of inflation are minimized.

A portion of our revenue is related to healthcare insurance and reinsurance products that are subject to the effects of the underlying inflation of healthcare costs. Such inflation in the costs of healthcare tends to generate increases in premiums for medical stop-loss coverage, resulting in greater revenue but also higher claim payments. Inflation also may have a negative impact on insurance and reinsurance operations by causing higher claim settlements than may originally have been estimated, without an immediate increase in premiums to a level necessary to maintain profit margins. We do not specifically provide for inflation when setting underwriting terms and claim reserves, although we do consider trends. We continually review claim reserves to assess their adequacy and make necessary adjustments.

Inflation can also affect interest rates. Any significant increase in interest rates could have a material adverse effect on the fair value of our investments. In addition, the interest rate payable under our Revolving Loan Facility fluctuates with market interest rates. Any significant increase in interest rates could have a material adverse effect on our net earnings, depending on the unhedged amount borrowed on that facility. We

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have entered into interest rate swap agreements that fix the interest rate on the \$200.0 million outstanding balance of our Revolving Loan Facility at 4.6% through November 2009.

### **Foreign Exchange Rate Fluctuations**

We underwrite risks that are denominated in a number of foreign currencies. As a result, we have receivables and payables in foreign currencies and we establish and maintain loss reserves with respect to our insurance policies in their respective currencies. There could be a negative impact on our net earnings from the effect of exchange rate fluctuations on these assets and liabilities. Our principal area of exposure is related to fluctuations in the exchange rates between the British pound sterling, the Euro and the U.S. dollar. We constantly monitor the balance between our receivables and payables and loss reserves to mitigate the potential exposure should an imbalance be expected to exist for other than a short period of time. Imbalances are generally net liabilities, and we hedge such imbalances with cash and short-term investments denominated in the same foreign currency as the net imbalance. Our loss from currency conversion, excluding a \$13.4 million charge, was \$1.8 million in 2007 compared to zero in 2006 and \$1.0 million in 2005. This charge was to correct the accounting for unrealized cumulative foreign exchange gains related to certain available for sale securities discussed previously. This loss was offset by a \$13.4 million realized gain for embedded net foreign currency exchange gains when the securities were sold in 2007.

### **Critical Accounting Policies**

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) requires us to make estimates and assumptions when applying our accounting policies. The following sections provide information about our estimation processes related to certain of our critical accounting policies.

#### ***Loss and Loss Adjustment Expense***

Our net loss and loss adjustment expense reserves are composed of reserves for reported losses and reserves for incurred but not reported losses, less a reduction for reinsurance recoverables related to those reserves. Reserves are recorded by product line and are undiscounted, except for reserves related to acquisitions.

The process of estimating our loss and loss adjustment expense reserves involves a considerable degree of judgment by management and is inherently uncertain. The recorded reserves represent management's best estimate of unpaid loss and loss adjustment expense by line of business. Because we provide insurance coverage in specialized lines of business that often lack statistical stability, management considers many factors, and not just the actuarial point estimates discussed below, in determining ultimate expected losses and the level of net reserves required and recorded.

To record reserves on our lines of business, we utilize expected loss ratios, which management selects based on the following: 1) information used to price the applicable policies, 2) historical loss information where available, 3) any public industry data for that line or similar lines of business and 4) an assessment of current market conditions. Management also considers the point estimates and ranges calculated by our actuaries, together with input from our experienced underwriting and claims personnel. Because of the nature and complexities of the specialized types of business we insure, management may give greater weight to the expectations of our underwriting and claims personnel, who often perform a claim by claim review, rather than to the actuarial estimates. However, we utilize the actuarial point and range estimates to monitor the adequacy and reasonableness of our recorded reserves.

Each quarter-end, management compares recorded reserves to the most recent actuarial point estimate and range for each line of business. If the recorded reserves vary significantly from the actuarial point estimate, management

determines the reasons for the variances and may adjust the reserves up or down to an amount that, in management's judgment, is adequate based on all of the facts and circumstances considered, including the actuarial point estimates. We consistently maintain total consolidated net reserves above the total actuarial point estimate but within the actuarial range.

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The table below shows our recorded net reserves at December 31, 2007 by line of business, the actuarial reserve point estimates, and the high and low ends of the actuarial reserve range as determined by our reserving actuaries.

|                                 | <b>Recorded<br/>Net Reserves</b> | <b>Actuarial<br/>Point<br/>Estimate</b> | <b>Low End of<br/>Actuarial<br/>Range</b> | <b>High End of<br/>Actuarial<br/>Range</b> |
|---------------------------------|----------------------------------|---|---|--|
| <b>Total net reserves</b>       | \$ 2,342,800                     | \$ 2,248,305                            | \$ 2,094,693                              | \$ 2,467,472                               |
| Individual lines of business:   |                                  |   |   |  |
| Diversified financial products  | \$ 1,038,444                     | \$ 991,359                              | \$ 850,959                                | \$ 1,175,578                               |
| Group life, accident and health | 330,603                          | 320,360                                 | 290,854                                   | 352,117                                    |
| Aviation                        | 104,885                          | 101,016                                 | 93,322                                    | 110,314                                    |
| London market account           | 209,885                          | 199,111                                 | 189,156                                   | 224,939                                    |
| Other specialty lines           | 226,669                          | 213,238                                 | 201,718                                   | 241,312                                    |
| Discontinued lines              | 432,314                          | 423,221                                 | 371,976                                   | 510,904                                    |
| <b>Total net reserves</b>       | <b>\$ 2,342,800</b>              |   |   |  |

The excess of the total recorded net reserves over the actuarial point estimate was 4.2% of recorded net reserves at December 31, 2007 compared to 2.2% at December 31, 2006. The percentage will vary in total and by line depending on current economic events, the potential volatility of the line, the severity of claims reported and of claims incurred but not reported, management's judgment with respect to the risk of development, the nature of business acquired in acquisitions and historical development patterns.

The actuarial point estimates represent our actuaries' estimate of the most likely amount that will ultimately be paid to settle the net reserves we have recorded at a particular point in time. While, from an actuarial standpoint, a point estimate is considered the most likely amount to be paid, there is inherent uncertainty in the point estimate, and it can be thought of as the expected value in a distribution of possible reserve estimates. The actuarial ranges represent our actuaries' estimate of a likely lowest amount and highest amount that will ultimately be paid to settle the net reserves we have recorded at a particular point in time. While there is still a possibility of ultimately paying an amount below the range or above the range, the actuarial probability is very small. The range determinations are based on estimates and actuarial judgments and are intended to encompass reasonably likely changes in one or more of the variables that were used to determine the point estimates.

The low end of the actuarial range and the high end of the actuarial range for the total net reserves will not equal the sum of the low and high ends for the individual lines of business. Moreover, in actuarial terms, it would not be appropriate to add the ranges for each line of business to obtain a range around the total net reserves because this would not reflect the diversification effects across our various lines of business. The diversification effects result from the fact that losses across the different lines of business are not completely correlated.

In actuarial practice, some of our lines of business are more effectively modeled by a statistical distribution that is skewed or non-symmetric. These distributions are usually skewed towards large losses, which causes the midpoint of the range to be above the actuarial point estimate or mean value of the range. This should be kept in mind when using the midpoint as a proxy for the mean. Our assumptions, estimates and judgments can change based on new information and changes in conditions and, if they change, it will affect the determination of the range amounts.





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The following table details, by major products within our lines of business, the characteristics and major actuarial assumptions utilized by our actuaries in the determination of actuarial point estimates and ranges. We considered all major lines of business written by the insurance industry when determining the relative characteristics of claims duration, speed of loss reporting and reserve volatility. Other companies may classify their own insurance products in different lines of business or utilize different actuarial assumptions.

| Line of Business                | Products                         | Underwriting            | Claims Characteristics |                          |                    | Major Actuarial Assumptions   |
|---------------------------------|----------------------------------|-------------------------|------------------------|--------------------------|--------------------|---|
|                                 |                                  |                         | Duration               | Speed of Claim Reporting | Reserve Volatility |   |
| Diversified financial products  | Directors and officers liability | Direct and subscription | Medium to long         | Moderate                 | Medium to high     | Historical and industry loss reporting patterns   |
|                                 | Professional indemnity           | Direct                  | Medium                 | Moderate                 | Medium             | Historical loss reporting patterns  |
|                                 | Surety                           | Direct                  | Medium                 | Fast                     | Low                | Historical loss payment and reporting patterns  |
| Group life, accident and health | Medical stop-loss                | Direct                  | Short                  | Fast                     | Low                | Medical cost and utilization trends<br>Historical loss payment and reporting patterns<br>Rate changes |
|                                 | Medical excess                   | Direct and assumed      | Short                  | Fast                     | Low to medium      | Historical loss payment and reporting patterns  |
| Aviation                        | Aviation                         | Direct and subscription | Medium                 | Fast                     | Medium             | Historical loss payment and reporting patterns  |
| London market account           | Accident and health              | Direct and assumed      | Medium to long         | Slow                     | High               | Historical loss payment and reporting patterns  |
|                                 | Energy*                          | Subscription            | Medium                 | Moderate                 | Medium             | Historical and industry loss payment and reporting patterns<br>Historical large loss experience       |

|                 |                                 |                    |                |          |                |  |
|-----------------|---------------------------------|--------------------|----------------|----------|----------------|--|
|                 | Property*                       | Subscription       | Medium         | Moderate | Medium         | Historical loss payment and reporting patterns<br>Historical large loss experience |
|                 | Marine                          | Subscription       | Medium         | Moderate | Medium         | Historical loss payment and reporting patterns<br>Historical large loss experience |
| Other specialty | Liability                       | Direct and assumed | Medium         | Moderate | Medium         | Historical loss payment and reporting patterns                                     |
|                 | Property                        | Direct and assumed | Short          | Fast     | Low            | Historical loss payment and reporting patterns                                     |
| Discontinued    | Accident and health reinsurance | Assumed            | Long           | Slow     | High           | Historical and industry loss payment and reporting patterns                        |
|                 | Medical malpractice             | Direct             | Medium to long | Moderate | Medium to high | Historical loss payment and reporting patterns                                     |

\* Includes catastrophe losses

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Direct insurance is coverage that is originated by our insurance companies and brokers in return for premium. Assumed reinsurance is coverage written by another insurance company, for which we assume all or a portion of the risk in exchange for all or a portion of the premium. Subscription business is direct insurance or assumed reinsurance where we only take a percentage of the total risk and premium and other insurers take their proportionate percentage of the remaining risk and premium. Assumed reinsurance represented 18% of our gross written premium in 2007 and 28% of our gross reserves at December 31, 2007. Approximately 39% of the assumed reinsurance reserves related to business in our discontinued lines, 30% related to assumed reinsurance in our London market account, aviation and diversified financial products lines of business, 13% related to assumed quota share surplus lines business in our other specialty lines, 9% related to assumed business in our group life, accident and health line of business, and 9% related Lloyd's of London business in our other specialty lines. The remaining assumed reinsurance reserves covered various other reinsurance programs. The table above recaps the underwriting, claims characteristics and major actuarial assumptions for our assumed reinsurance business.

The run-off assumed accident and health reinsurance business is primarily reinsurance that provides excess coverage for large losses related to workers' compensation policies. As discussed previously, we recorded significant increases in assumed reserves in 2003, 2004 and 2005. These losses resulted from late reporting of claims by cedants and state guaranty associations and changes in our actuarial assumptions related to this business. To mitigate our exposure to unexpected losses reported by cedants, our claims personnel review reported losses to ensure they are reasonable and consistent with our expectations. In addition, our claims personnel periodically audit the cedants' claims processing functions to assess whether cedants are submitting timely and accurate claims reports to us. Disputes with insureds related to claims or coverage issues are administered in the normal course of business or settled through arbitration. Based on the negative factors we experienced and the higher risk of this discontinued line of business relative to our continuing lines of business, management believes there may be a greater likelihood of future adverse development in the run-off assumed accident and health reinsurance business than in our other lines of business. We periodically reassess loss reserves for this assumed business and adjust them, if needed.

Our assumed quota share surplus lines business in our other specialty lines is recorded monthly with a two-month time lag. Case reserves are reported directly to us by the cedant, and we establish incurred but not reported reserves based on our estimates. We periodically contact and visit the cedant to discuss loss trends and review claim files. We also receive copies of the cedant's loss triangles on individual products. Because of the frequent communication, we receive sufficient information to use many of the same methods and assumptions we would use to set reserves for comparable direct business. We have not had any disputes with the cedant.

The majority of the assumed reinsurance in our London market account, aviation and diversified financial products lines of business is facultative reinsurance. This business involves reinsurance of a company's entire captive insurance program or business that must be written through another insurance company licensed to write insurance in a particular country or locality. In all cases, we underwrite the business and administer the claims, which are reported without a lag by the brokers. Disputes, if any, generally relate to claims or coverage issues with insureds and are administered in the normal course of business. We establish loss reserves for this assumed reinsurance using the same methods and assumptions we use to set reserves for comparable direct business.

The majority of the assumed reinsurance in our group life, accident and health line of business is due to medical excess products in our Health Products Division. Although very similar to our direct medical stop-loss business, it is written as excess reinsurance of HMOs, provider groups, hospitals and other insurance companies. Our Lloyd's of London business is reported as reinsurance. We underwrite the assumed group life, accident and health and Lloyd's of London business and administer the claims. Disputes, if any, are administered in the normal course of business. We establish loss reserves for this business using the same methods and assumptions we would use to set reserves for comparable direct business.



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The following tables show the composition of our gross, ceded and net reserves at the respective balance sheet dates.

|   | <b>Gross</b>        | <b>Ceded</b>      | <b>Net</b>          | <b>% Net<br/>IBNR to<br/>Net<br/>Total<br/>Reserves</b> |
|---|---------------------|-------------------|---------------------|---|
| <b><u>At December 31, 2007</u></b>                    |                     |                   |                     |   |
| Reported loss reserves:                               |                     |                   |                     |   |
| Diversified financial products                        | \$ 593,378          | \$ 187,256        | \$ 406,122          |   |
| Group life, accident and health                       | 194,670             | 2,244             | 192,426             |   |
| Aviation  | 116,983             | 44,219            | 72,764              |   |
| London market account                                 | 242,918             | 134,658           | 108,260             |   |
| Other specialty lines                                 | 131,012             | 45,672            | 85,340              |   |
| Subtotal reported reserves                            | 1,278,961           | 414,049           | 864,912             |   |
| Incurred but not reported reserves:                   |                     |                   |                     |   |
| Diversified financial products                        | 892,669             | 260,347           | 632,322             | 61%   |
| Group life, accident and health                       | 157,213             | 19,036            | 138,177             | 42  |
| Aviation  | 52,771              | 20,650            | 32,121              | 31  |
| London market account                                 | 134,398             | 32,773            | 101,625             | 48  |
| Other specialty lines                                 | 211,798             | 70,469            | 141,329             | 62  |
| Subtotal incurred but not reported reserves           | 1,448,849           | 403,275           | 1,045,574           | 55  |
| Discontinued lines reported reserves                  | 335,177             | 44,141            | 291,036             |   |
| Discontinued lines incurred but not reported reserves | 164,093             | 22,815            | 141,278             | 33  |
| <b>Total loss and loss adjustment expense payable</b> | <b>\$ 3,227,080</b> | <b>\$ 884,280</b> | <b>\$ 2,342,800</b> | <b>51%</b>  |
| <b><u>At December 31, 2006</u></b>                    |                     |                   |                     |   |
| Reported loss reserves:                               |                     |                   |                     |   |
| Diversified financial products                        | \$ 507,739          | \$ 177,274        | \$ 330,465          |   |
| Group life, accident and health                       | 156,058             | 1,627             | 154,431             |   |
| Aviation  | 108,851             | 39,506            | 69,345              |   |
| London market account                                 | 311,862             | 206,344           | 105,518             |   |
| Other specialty lines                                 | 83,105              | 30,231            | 52,874              |   |
| Subtotal reported reserves                            | 1,167,615           | 454,982           | 712,633             |   |
| Incurred but not reported reserves:                   |                     |                   |                     |   |
| Diversified financial products                        | 782,571             | 264,400           | 518,171             | 61%   |
| Group life, accident and health                       | 176,955             | 14,210            | 162,745             | 51  |
| Aviation  | 63,460              | 28,592            | 34,868              | 33  |
| London market account                                 | 142,358             | 42,192            | 100,166             | 49  |
| Other specialty lines                                 | 150,459             | 51,405            | 99,054              | 65  |

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|   |                     |                   |                     |            |
|---|---------------------|-------------------|---------------------|------------|
| Subtotal incurred but not reported reserves           | 1,315,803           | 400,799           | 915,004             | 56         |
| Discontinued lines reported reserves                  | 398,193             | 74,580            | 323,613             |            |
| Discontinued lines incurred but not reported reserves | 215,440             | 57,729            | 157,711             | 33         |
| <b>Total loss and loss adjustment expense payable</b> | <b>\$ 3,097,051</b> | <b>\$ 988,090</b> | <b>\$ 2,108,961</b> | <b>51%</b> |

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We determine our incurred but not reported reserves by first projecting the ultimate expected losses by product within each line of business. We then subtract paid losses and reported loss reserves from the ultimate loss reserves. The remainder is our incurred but not reported reserves. The level of incurred but not reported reserves in relation to total reserves depends upon the characteristics of the specific line of business, particularly with respect to the speed with which losses are reported and outstanding claims reserves are adjusted. Lines for which losses are reported fast will have a lower percentage of incurred but not reported loss reserves than slower reporting lines, and lines for which reserve volatility is low will have a lower percentage of incurred but not reported loss reserves than high volatility lines.

The reserves for reported losses related to our direct business and certain reinsurance assumed are initially set by our claims personnel or independent claims adjusters we retain. The reserves are subject to our review, with a goal of setting them at the ultimate expected loss amount as soon as possible when the information becomes available. Reserves for reported losses related to other reinsurance assumed are recorded based on information supplied to us by the ceding company. Our claims personnel monitor these reinsurance assumed reserves on a current basis and audit ceding companies' claims to ascertain that claims are being recorded currently and that net reserves are being set at levels that properly reflect the liability related to the claims.

The percentage of net incurred but not reported reserves to net total reserves was 51% at both December 31, 2007 and 2006. The reasons, by line of business, for changes in net reserves and the percentage of incurred but not reported reserves to total net reserves, other than changes related to normal maturing of claims, follow:

**Diversified financial products** Total net reserves in our diversified financial products line of business increased \$189.8 million from 2006 to 2007 as this relatively new line of business continues to grow. The incurred but not reported portion of the total reserves for this line of business is higher than in most of our other lines, since these losses report slower and have a longer duration. The percentage will decrease as the claims start to mature.

**Group life, accident and health** The percentage of incurred but not reported reserves decreased in 2007 as we integrated the Health Products Division, acquired in 2006, into our normal reserving practices. The acquired reserves did not include a case basis factor similar to our other medical stop-loss reserves. This refinement caused a reduction in incurred but not reported reserves and an increase in reported loss reserves.

**Other specialty lines** Total net reserves increased \$74.7 million due to increased participation and activity in our Lloyd's of London syndicate and more assumed quota share surplus lines business.

**Discontinued lines** Total net reserves for our discontinued lines decreased \$49.3 million in 2007 as a result of claims payments.

Our net reserves historically have shown favorable development except for the effects of commutations, which we have completed in the past and may negotiate in the future. Commutations can produce adverse prior year development since, under generally accepted accounting principles, any excess of undiscounted reserves assumed over assets received must be recorded as a loss at the time the commutation is completed. Economically, the loss generally represents the discount for the time value of money that will be earned over the payout of the reserves; thus, the loss may be recouped as investment income is earned on the assets received. Based on our reserving techniques and our past results, we believe that our net reserves are adequate.

We conducted a detailed review of our loss exposure to current market events, including subprime issues that have recently affected credit markets in the United States. In reviewing our exposure, we considered the types of risks we wrote, the industry of our insured, attachment points with respect to excess business, types of coverage, policy limits,

actual claims reported, and current legal interpretations and decisions. Based on that review and our current knowledge, we believe our losses with respect to current events will be contained within the applicable loss reserves that have been recorded for the related exposures.



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We have no material exposure to asbestos claims or environmental pollution losses. Our largest insurance company subsidiary only began writing business in 1981, and its policies normally contain pollution exclusion clauses that limit pollution coverage to sudden and accidental losses only, thus excluding intentional dumping and seepage claims. Policies issued by our other insurance company subsidiaries do not have significant environmental exposures because of the types of risks covered.

### ***Reinsurance Recoverables***

We limit our liquidity exposure for uncollected recoverables by holding funds, letters of credit or other security, such that net balances due from reinsurers are significantly less than the gross balances shown in our consolidated balance sheets. We constantly monitor the collectibility of the reinsurance recoverables of our insurance companies and record a reserve for uncollectible reinsurance when we determine an amount is potentially uncollectible. Our evaluation is based on our periodic reviews of our disputed and aged recoverables, as well as our assessment of recoverables due from reinsurers known to be in financial difficulty. In some cases, we make estimates as to what portion of a recoverable may be uncollectible. Our estimates and judgment about the collectibility of the recoverables and the financial condition of reinsurers can change, and these changes can affect the level of reserve required.

The reserve was \$8.5 million at December 31, 2007, compared to \$14.9 million at December 31, 2006. We increased the reserve in 2007 by \$2.2 million to cover additional recoverables for which changed conditions caused us to believe that part or all of the outstanding balances may not be collectible. We wrote off \$8.6 million of uncollectible balances in 2007. We assessed the collectibility of our year-end recoverables and believe amounts are collectible and any potential losses are adequately reserved based on currently available information.

### ***Deferred Taxes***

We recognize deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. We regularly review our deferred tax assets for recoverability and establish a valuation allowance based on our history of earnings, expectations for future earnings, taxable income in carry back years and the expected timing of the reversals of existing temporary differences. Although realization is not assured, we believe that, as of December 31, 2007, it is more likely than not that we will be able to realize the benefit of recorded deferred tax assets, with the exception of certain pre-acquisition tax loss carryforwards for which valuation allowances have been provided. If there is a material change in the tax laws such that the actual effective tax rate changes or the time periods within which the underlying temporary differences become taxable or deductible change, we will need to reevaluate our assumptions, which could result in a change in the valuation allowance required.

### ***Valuation of Goodwill***

We assess the impairment of goodwill annually, or sooner if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. In determining the fair value of a reporting unit, we utilize the expected cash flow approach in Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Values in Accounting Measurements*. This approach utilizes estimated future cash flows, probabilities as to occurrence of these cash flows, a risk-free rate of interest and a risk premium for uncertainty in the cash flows. We utilize our budgets and projections of future operations based on historical and expected industry trends to estimate our future cash flows and the probability of their occurring as projected. Based on our latest impairment test, the fair value of each of our reporting units exceeded its carrying amount by a satisfactory margin.

### ***Other-Than-Temporary Impairments on Investments***

Declines in the market value of invested assets below cost are evaluated for other-than-temporary impairment losses on a quarterly basis. Impairment losses for declines in value of fixed income securities below cost attributable to issuer-specific events, including recent subprime market issues, are based on all

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relevant facts and circumstances for each investment and are recognized when appropriate. For fixed income securities with unrealized losses due to market conditions or industry-related events where we have the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary. At December 31, 2007, we had gross unrealized losses on fixed income securities of \$18.3 million (0.5% of aggregate fair value) compared to \$24.3 million (0.8% of aggregate fair value) at December 31, 2006. We did not have any impairment losses in 2007 or 2006 with respect to these securities.

## **Recent Accounting Pronouncements**

FIN No. 48, *Accounting for Uncertainty in Income Taxes*, became effective January 1, 2007. Under FIN 48, a company may only recognize the tax benefit from an uncertain tax position if it is more likely than not the tax position will be sustained upon examination by the tax authority. See Note 7 to our Consolidated Financial Statements for discussion about our adoption of FIN 48.

The FASB has issued SFAS No. 157, *Fair Value Measurements*, which clarifies the definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. The FASB has also issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows a company to measure fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. Unrealized gains and losses for those items are reported in current earnings at each subsequent reporting date. Both SFAS 157 and SFAS 159 are effective January 1, 2008. We do not expect their adoption to have a material impact on our consolidated financial statements.

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

## **Item 7A. *Quantitative and Qualitative Disclosures About Market Risk***

Our principal assets and liabilities are financial instruments that are subject to the market risk of potential losses from adverse changes in market rates and prices. Our primary market risk exposures are interest rate risk on fixed income securities and variable rate debt and on foreign currency exchange rate risk.

Caution should be used in evaluating overall market risk utilizing the information below. Actual results could differ materially from estimates below for a variety of reasons, including: 1) amounts and balances on which the estimates are based are likely to change over time, 2) assumptions used in the models may prove to be inaccurate, 3) market changes could be different from market changes assumed below and 4) not all factors and balances are taken into account.

## **Interest Rate Risk**

To manage the exposures of our investment risks, we generally invest in investment grade securities with characteristics of duration and liquidity to reflect the underlying characteristics of the insurance liabilities of our

insurance companies. We have not used derivatives to manage any of our investment-related market risks. The value of our portfolio of fixed income securities is inversely correlated to changes in the market interest rates. In addition, some of our fixed income securities have call or prepayment options. This could subject us to reinvestment risk should interest rates fall or issuers call their securities and we reinvest the proceeds at lower interest rates. We attempt to mitigate this risk by investing in securities with varied maturity dates, so that only a portion of the portfolio will mature at any point in time.

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The fair value of our fixed income securities was \$3.7 billion at December 31, 2007 and \$3.0 billion at December 31, 2006. If market interest rates were to change 1% (e.g. from 5% to 6%), the fair value of our fixed income securities would have changed approximately \$179.7 million at December 31, 2007. This compares to a change in fair value of \$138.3 million at December 31, 2006 for the same 1% change in market interest rates. The change in fair value was determined using duration modeling assuming no prepayments.

Our \$575.0 million Revolving Loan Facility is subject to variable interest rates. At December 31, 2007, the outstanding balance of \$200.0 million was effectively converted to fixed rate debt at 4.6% through the use of interest rate swaps. Our 1.30% Convertible Notes are not subject to interest rate changes.

**Foreign Exchange Risk**

The table below shows the net amounts of significant foreign currency balances for subsidiaries with a U.S. dollar functional currency at December 31, 2007 and 2006 converted to U.S. dollars. It also shows the expected dollar change in fair value (in thousands) that would occur if exchange rates changed 10% from exchange rates in effect at those times.

|                        | December 31,                 |                                |                              |                                |
|------------------------|------------------------------|--------------------------------|------------------------------|--------------------------------|
|                        | 2007                         | Hypothetical                   |                              | 2006                           |
|                        | U.S.<br>Dollar<br>Equivalent | 10% Change<br>in Fair<br>Value | U.S.<br>Dollar<br>Equivalent | 10% Change<br>in Fair<br>Value |
| British pound sterling | \$ 42,340                    | \$ 4,234                       | \$ 37,701                    | \$ 3,770                       |
| Euro                   | 1,041                        | 104                            | 1,942                        | 194                            |
| Canadian dollar        | 1,355                        | 135                            | 816                          | 82                             |

See Foreign Exchange Rate Fluctuations section contained in Item 7, Management's Discussion and Analysis, and Note 1 in the Notes to Consolidated Financial Statements for additional information.

**Item 8. Financial Statements and Supplementary Data**

The financial statements and financial statement schedules listed in the accompanying Index to Consolidated Financial Statements and Schedules are filed as part of this Report.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures**

None.

**Item 9A. Controls and Procedures****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 December 31, 2007. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of December 31, 2007.

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**Management's Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America (generally accepted accounting principles). Internal control over financial reporting includes those policies and procedures that: 1) pertain to the maintenance of our records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of our assets, 2) provide reasonable assurance that we have recorded transactions as necessary to permit us to prepare consolidated financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of our management and Board of Directors and 3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our consolidated financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Management, including our CEO and CFO, conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2007 based on criteria established in the *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on the results of this assessment, management concluded that our internal control over financial reporting was effective as of December 31, 2007 and that the consolidated financial statements included in this Report present fairly, in all material respects, our financial position, results of operations and cash flows for the years presented in accordance with generally accepted accounting principles.

The effectiveness of our internal control over financial reporting as of December 31, 2007 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report, which is included in Item 8 of this Report.

**Changes in Internal Control Over Financial Reporting**

During the fourth quarter of 2007, there were no changes in our internal control of financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

We have disclosed all information required to be disclosed in a current report on Form 8-K during the fourth quarter of 2007 in previously filed reports on Form 8-K.

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**PART III**

**Item 10. *Directors, Executive Officers and Corporate Governance***

**Code of Business Conduct and Ethics**

We have adopted a Code of Business Conduct and Ethics which applies to all employees, officers and directors of our company. The complete text of our Code of Business Conduct and Code of Ethics is available on our website at [www.hcc.com](http://www.hcc.com) and will be provided to any person free of charge upon request made to: HCC Insurance Holdings, Inc., Investor Relations Department, 13403 Northwest Freeway, Houston, Texas 77040. Any amendments to, or waivers of, the Code of Business Conduct and Ethics which apply to the Chief Executive Officer and the Senior Financial Officers will be disclosed on our website.

For information regarding our Directors, Executive Officers and Corporate Governance, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2007 and which is incorporated herein by reference.

On May 17, 2007, we filed with the New York Stock Exchange the Annual CEO Certification regarding our compliance with the New York Stock Exchange's Corporate Governance listing standards as required by Section 303A-12(a) of the New York Stock Exchange Listed Company Manual. The Annual CEO Certification was issued without qualification. In addition, we have filed as exhibits to this Annual Report on Form 10-K for the year ended December 31, 2007 and to the Annual Report on Form 10-K for the year ended December 31, 2006, the applicable certifications of our Chief Executive Officer and our Chief Financial Officer required under Section 302 of the Sarbanes-Oxley Act of 2002.

**Item 11. *Executive Compensation***

For information regarding Executive Compensation, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2007 and which is incorporated herein by reference.

**Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

For information regarding Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2007 and which is incorporated herein by reference.

**Item 13. *Certain Relationships and Related Transactions and Director Independence***

For information regarding Certain Relationships and Related Transactions and Director Independence, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2007 and which is incorporated herein by reference.

**Item 14. *Principal Accountant Fees and Services***



For information regarding Principal Accountant Fees and Services, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2007 and which is incorporated herein by reference.

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**PART IV**

**Item 15. *Exhibits and Financial Statement Schedules***

*(a) Financial Statement Schedules*

The financial statements and financial statement schedules listed in the accompanying Index to Consolidated Financial Statements and Schedules are filed as part of this Report.

*(b) Exhibits*

The exhibits listed on the accompanying Index to Exhibits are filed as part of this Report.

**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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)

By:  
/s/ Frank J. Bramanti  
(Frank J. Bramanti)  
*Chief Executive Officer*

Dated: February 29, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| <b>Name</b>  | <b>Title</b>  | <b>Date</b>       |
|--|---|-------------------|
| /s/ Frank J. Bramanti<br>(Frank J. Bramanti)       | Director and Chief Executive Officer<br>(Principal Executive Officer)                           | February 29, 2008 |
| /s/ Patrick B. Collins*<br>(Patrick B. Collins)    | Director  | February 29, 2008 |
| /s/ J. Robert Dickerson*<br>(J. Robert Dickerson)  | Director, Chairman of the Board and<br>Lead Independent Director                                | February 29, 2008 |
| /s/ Walter M. Duer*<br>(Walter M. Duer)            | Director  | February 29, 2008 |
| /s/ Edward H. Ellis, Jr.<br>(Edward H. Ellis, Jr.) | Director, Executive Vice President and<br>Chief Financial Officer<br>(Chief Accounting Officer) | February 29, 2008 |
| /s/ James C. Flagg, Ph.D.*                         | Director  | February 29, 2008 |

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(James C. Flagg, Ph.D.)

/s/ Allan W. Fulkerson\* Director February 29, 2008

(Allan W. Fulkerson)

/s/ John N. Molbeck, Jr.\* Director, President and Chief Operating Officer February 29, 2008

(John N. Molbeck, Jr.)

/s/ James E. Oesterreicher\* Director February 29, 2008

(James E. Oesterreicher)

/s/ Michael A. F. Roberts\* Director February 29, 2008

(Michael A. F. Roberts)

/s/ Christopher J. B. Williams\* Director February 29, 2008

(Christopher J. B. Williams)

\*By: /s/ Edward H. Ellis, Jr.

Edward H. Ellis, Jr.,  
*Attorney-in-fact*

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**INDEX TO EXHIBITS**

*Items denoted by a letter are incorporated by reference to other documents previously filed with the Securities and Exchange Commission as set forth at the end of this index. Items not denoted by a letter are being filed herewith.*

**Exhibit  
Number**

- A3.1 Restated Certificate of Incorporation and Amendment of Certificate of Incorporation of HCC Insurance Holdings, Inc., filed with the Delaware Secretary of State on July 23, 1996 and May 21, 1998, respectively.
- B3.2 Bylaws of HCC Insurance Holdings, Inc., as amended.
- B4.1 Specimen of Common Stock Certificate, \$1.00 par value, of HCC Insurance Holdings, Inc.
- C4.2 Indenture dated August 23, 2001 between HCC Insurance Holdings, Inc. and First Union National Bank related to Debt Securities (Senior Debt).
- D4.3 Second Supplemental Indenture dated March 28, 2003 between HCC Insurance Holdings, Inc. and Wachovia Bank, National Association (as successor to First Union National Bank) related to 1.30% Convertible Notes Due 2023.
- E4.4 First Amendment to Second Supplemental Indenture dated December 22, 2004 between HCC Insurance Holdings, Inc. and Wachovia Bank, National Association related to 1.30% Convertible Notes Due 2023.
- F10.1 Loan Agreement (\$300,000,000 Revolving Loan Facility) dated as of April 4, 2007 among HCC Insurance Holdings, Inc.; Wells Fargo Bank, National Association; Citibank, N.A.; Wachovia Bank, National Association; Royal Bank of Scotland; Amegy Bank, National Association and The Bank of New York.
- G10.2 First Amendment to Loan Agreement dated as of October 23, 2007 by and among HCC Insurance Holdings, Inc. and Wells Fargo Bank, National Association; Citibank, N.A.; Wachovia Bank, National Association; Royal Bank of Scotland; Amegy Bank, National Association; The Bank of New York; Key Bank National Association; Bank of America, N.A.; and Deutsche Bank AG New York Branch.
- H10.3 Master Agreement dated August 3, 2006 by and among Allianz Life Insurance Company of North America, Allianz Life Insurance Company of New York and HCC Life Insurance Company.
- I10.4 HCC Insurance Holdings, Inc. 2001 Flexible Incentive Plan, as amended and restated.
- J10.5 Form of Incentive Stock Option Agreement under the HCC Insurance Holdings, Inc. 2001 Flexible Incentive Plan.
- K10.6 HCC Insurance Holdings, Inc. 2004 Flexible Incentive Plan.
- L10.7 Form of Incentive Stock Option Agreement under the HCC Insurance Holdings, Inc. 2004 Incentive Plan.
- M10.8 HCC Insurance Holdings, Inc. 2007 Incentive Compensation Plan.
- N10.9 Employment Agreement effective January 1, 2007, between HCC Insurance Holdings, Inc. and Frank J. Bramanti.
- O10.10 Employment Agreement effective March 1, 2007, between HCC Insurance Holdings, Inc. and John N. Molbeck, Jr.
- O10.11 Employment Agreement effective March 1, 2007, between HCC Insurance Holdings, Inc. and Craig J. Kelbel.
- O10.12 Employment Agreement effective June 1, 2007, between HCC Insurance Holdings, Inc. and Michael J. Schell.
- O10.13

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- Employment Agreement effective March 1, 2007, between HCC Insurance Holdings, Inc. and Edward H. Ellis, Jr.
- P10.14 Service Agreement effective as of January 1, 2006, between HCC Service Company Limited (UK) Branch and Barry J. Cook.
- Q10.15 HCC Insurance Holdings, Inc. Nonqualified Deferred Compensation Plan for Frank J. Bramanti.
- Q10.16 HCC Insurance Holdings, Inc. Nonqualified Deferred Compensation Plan for John N. Molbeck.

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**Exhibit  
Number**

- R10.17 Consulting Agreement and Resignation effective as of November 17, 2006 by and between HCC Insurance Holdings, Inc. and Stephen L. Way.
  - S10.18 Amendment No. 1 to Consulting Agreement and Resignation effective as of February 21, 2007 by and between HCC Insurance Holdings, Inc. and Stephen L. Way.
  - 12 Statement Regarding Computation of Ratios.
  - 21 Subsidiaries of HCC Insurance Holdings, Inc.
  - 23 Consent of Independent Registered Public Accounting Firm PricewaterhouseCoopers LLP dated February 29, 2008.
  - 24 Powers of Attorney.
  - 31.1 Certification by Chief Executive Officer.
  - 31.2 Certification by Chief Financial Officer.
  - 32.1 Certification with respect to Annual Report of HCC Insurance Holdings, Inc.
- A Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Registration Statement on Form S-8 (Registration No. 333-61687) filed August 17, 1998.
- B Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Registration Statement on Form S-1 (Registration No. 33-48737) filed October 27, 1992.
- C Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated August 19, 2001.
- D Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated March 25, 2003.
- E Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated December 22, 2004.
- F Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated April 4, 2007.
- G Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated October 24, 2007.
- H Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-Q for the quarter ended June 30, 2006.
- I Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Definitive Proxy Statement for the May 22, 2002 Annual Meeting of Shareholders filed April 26, 2002.
- J Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-K for the year ended December 31, 2002.
- K Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Definitive Proxy Statement for the May 13, 2004 Annual Meeting of Shareholders filed April 16, 2004.
- L Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-K for the year ended December 31, 2004.

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- <sup>M</sup> Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Definitive Proxy Statement for the May 10, 2007 Annual Meeting of Shareholders filed April 13, 2007.
- <sup>N</sup> Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated April 12, 2007.
- <sup>O</sup> Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated August 10, 2007.
- <sup>P</sup> Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-Q for the quarter ended March 31, 2007.
- <sup>Q</sup> Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated August 30, 2007.



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Schedules other than those listed above have been omitted because they are either not required, not applicable, or the required information is shown in the Consolidated Financial Statements and Notes thereto or other Schedules.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders  
HCC Insurance Holdings, Inc.

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of HCC Insurance Holdings, Inc. and its subsidiaries at December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedules, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for uncertain tax positions in 2007 and the manner in which it accounts for share-based compensation in 2006.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become

inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Houston, TX

February 29, 2008

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(in thousands, except per share data)**

|   | <b>December 31,</b> |                     |
|---|---------------------|---------------------|
|   | <b>2007</b>         | <b>2006</b>         |
| <b>ASSETS</b>   |                     |                     |
| Investments:  |                     |                     |
| Fixed income securities, at fair value (amortized cost: 2007 \$3,641,667; 2006 \$3,008,818)                                 | \$ 3,666,705        | \$ 3,007,193        |
| Short-term investments, at cost, which approximates fair value  | 783,650             | 714,685             |
| Other investments   | 221,922             | 206,117             |
| <b>Total investments</b>  | <b>4,672,277</b>    | <b>3,927,995</b>    |
| Cash  | 39,135              | 48,290              |
| Restricted cash and cash investments  | 193,151             | 176,424             |
| Premium, claims and other receivables   | 763,401             | 864,705             |
| Reinsurance recoverables  | 956,665             | 1,169,934           |
| Ceded unearned premium  | 244,684             | 226,125             |
| Ceded life and annuity benefits   | 66,199              | 70,923              |
| Deferred policy acquisition costs   | 192,773             | 182,410             |
| Goodwill  | 776,046             | 742,677             |
| Other assets  | 170,314             | 220,649             |
| <b>Total assets</b>   | <b>\$ 8,074,645</b> | <b>\$ 7,630,132</b> |
| <b>LIABILITIES</b>  |                     |                     |
| Loss and loss adjustment expense payable  | \$ 3,227,080        | \$ 3,097,051        |
| Life and annuity policy benefits  | 66,199              | 70,923              |
| Reinsurance balances payable  | 129,838             | 122,805             |
| Unearned premium  | 943,946             | 920,350             |
| Deferred ceding commissions   | 68,968              | 64,949              |
| Premium and claims payable  | 497,974             | 646,224             |
| Notes payable   | 324,714             | 308,887             |
| Accounts payable and accrued liabilities  | 375,561             | 356,140             |
| <b>Total liabilities</b>  | <b>5,634,280</b>    | <b>5,587,329</b>    |
| <b>SHAREHOLDERS EQUITY</b>  |                     |                     |
| Common stock, \$1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2007 115,069; 2006 111,731) | 115,069             | 111,731             |
| Additional paid-in capital  | 831,419             | 798,213             |
| Retained earnings   | 1,445,995           | 1,098,887           |
| Accumulated other comprehensive income  | 47,882              | 33,972              |

|  |              |              |
|--|--------------|--------------|
| <b>Total shareholders equity</b>                 | 2,440,365    | 2,042,803    |
| <b>Total liabilities and shareholders equity</b> | \$ 8,074,645 | \$ 7,630,132 |

See Notes to Consolidated Financial Statements.

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Table of Contents**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF EARNINGS**

(in thousands, except per share data)

|   | <b>Years Ended December 31,</b> |                   |                   |
|---|---------------------------------|-------------------|-------------------|
|   | <b>2007</b>                     | <b>2006</b>       | <b>2005</b>       |
| <b>REVENUE</b>  |                                 |                   |                   |
| Net earned premium  | \$ 1,985,086                    | \$ 1,709,189      | \$ 1,369,988      |
| Fee and commission income   | 140,092                         | 137,131           | 132,628           |
| Net investment income   | 206,462                         | 152,804           | 98,851            |
| Net realized investment gain (loss)                                   | 13,188                          | (841)             | 1,448             |
| Other operating income  | 43,545                          | 77,012            | 39,773            |
| <b>Total revenue</b>  | <b>2,388,373</b>                | <b>2,075,295</b>  | <b>1,642,688</b>  |
| <b>EXPENSE</b>  |                                 |                   |                   |
| Loss and loss adjustment expense, net                                 | 1,183,947                       | 1,011,856         | 919,697           |
| Policy acquisition costs, net   | 366,610                         | 319,885           | 261,708           |
| Other operating expense   | 241,642                         | 222,324           | 180,990           |
| Interest expense  | 10,304                          | 11,396            | 7,684             |
| <b>Total expense</b>  | <b>1,802,503</b>                | <b>1,565,461</b>  | <b>1,370,079</b>  |
| Earnings from continuing operations before income tax expense         | 585,870                         | 509,834           | 272,609           |
| Income tax expense on continuing operations                           | 190,441                         | 167,549           | 84,177            |
| Earnings from continuing operations                                   | 395,429                         | 342,285           | 188,432           |
| Earnings from discontinued operations, net of income taxes of \$1,686 |                                 |                   | 2,760             |
| <b>Net earnings</b>   | <b>\$ 395,429</b>               | <b>\$ 342,285</b> | <b>\$ 191,192</b> |
| <b>Basic earnings per share data:</b>                                 |                                 |                   |                   |
| Earnings from continuing operations                                   | \$ 3.50                         | \$ 3.08           | \$ 1.78           |
| Earnings from discontinued operations                                 |                                 |                   | 0.03              |
| <b>Net earnings</b>   | <b>\$ 3.50</b>                  | <b>\$ 3.08</b>    | <b>\$ 1.81</b>    |
| Weighted average shares outstanding                                   | 112,873                         | 111,309           | 105,463           |
| <b>Diluted earnings per share data:</b>                               |                                 |                   |                   |
| Earnings from continuing operations                                   | \$ 3.38                         | \$ 2.93           | \$ 1.72           |
| Earnings from discontinued operations                                 |                                 |                   | 0.03              |
| <b>Net earnings</b>   | <b>\$ 3.38</b>                  | <b>\$ 2.93</b>    | <b>\$ 1.75</b>    |

|                                     |         |         |         |
|-------------------------------------|---------|---------|---------|
| Weighted average shares outstanding | 116,997 | 116,736 | 109,437 |
|-------------------------------------|---------|---------|---------|

See Notes to Consolidated Financial Statements.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(in thousands)

|  | <b>Years Ended December 31,</b> |                   |                   |
|--|---------------------------------|-------------------|-------------------|
|  | <b>2007</b>                     | <b>2006</b>       | <b>2005</b>       |
| Net earnings   | \$ 395,429                      | \$ 342,285        | \$ 191,192        |
| Other comprehensive income (loss):   |                                 |                   |                   |
| Investment gains (losses):   |                                 |                   |                   |
| Investment gains (losses) during the year, net of income tax charge (benefit) of \$14,416 in 2007, \$14,212 in 2006, and \$(2,946) in 2005               | 27,464                          | 26,142            | (4,257)           |
| Less reclassification adjustment for gains included in net earnings, net of income tax charge of \$13,111 in 2007, \$13,484 in 2006, and \$2,479 in 2005 | (24,350)                        | (25,043)          | (4,605)           |
| Net investment gains (losses)  | 3,114                           | 1,099             | (8,862)           |
| Cash flow hedge loss, net of income tax benefit of \$871   | (1,617)                         |                   |                   |
| Foreign currency translation adjustment, net of income tax charge (benefit) of \$863 in 2007, \$3,249 in 2006, and \$(762) in 2005                       | 12,413                          | 13,799            | (9,699)           |
| Other comprehensive income (loss)  | 13,910                          | 14,898            | (18,561)          |
| <b>Comprehensive income</b>  | <b>\$ 409,339</b>               | <b>\$ 357,183</b> | <b>\$ 172,631</b> |

See Notes to Consolidated Financial Statements.



**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**

Years ended December 31, 2007, 2006 and 2005

(in thousands, except per share data)

|  | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Total<br/>Shareholders<br/>Equity</b> |
|--|-------------------------|---|------------------------------|---|--|
| <b>Balance at December 31, 2004</b>  | \$ 68,038               | \$ 582,566                                | \$ 637,259                   | \$ 37,635   | \$ 1,325,498                             |
| Net earnings   |                         |   | 191,192                      |   | 191,192                                  |
| Other comprehensive income   |                         |   |                              | (18,561)  | (18,561)                                 |
| Issuance of 4,688 shares in public offering, net of costs                          | 4,688                   | 145,276                                   |                              |   | 149,964                                  |
| Issuance of 2,439 shares for exercise of options, including tax benefit of \$6,168 | 1,785                   | 40,522                                    |                              |   | 42,307                                   |
| Issuance of 1,624 shares for purchased companies and convertible debt              | 1,227                   | 26,226                                    |                              |   | 27,453                                   |
| Stock-based compensation   |                         | 2,645                                     |                              |   | 2,645                                    |
| Three-for-two stock split  | 35,065                  | (35,065)                                  |                              |   |  |
| Cash dividends declared, \$0.282 per share   |                         |   | (30,063)                     |   | (30,063)                                 |
| <b>Balance at December 31, 2005</b>  | 110,803                 | 762,170                                   | 798,388                      | 19,074  | 1,690,435                                |
| Net earnings   |                         |   | 342,285                      |   | 342,285                                  |
| Other comprehensive income   |                         |   |                              | 14,898  | 14,898                                   |
| Issuance of 928 shares for exercise of options, including tax benefit of \$3,396   | 928                     | 18,071                                    |                              |   | 18,999                                   |
| Stock-based compensation   |                         | 14,022                                    |                              |   | 14,022                                   |
| Reimbursement, net of income taxes of \$2,127                                      |                         | 3,950                                     |                              |   | 3,950                                    |
| Cash dividends declared, \$0.375 per share   |                         |   | (41,786)                     |   | (41,786)                                 |
| <b>Balance at December 31, 2006</b>  | 111,731                 | 798,213                                   | 1,098,887                    | 33,972  | 2,042,803                                |
| Cumulative effect of accounting change (adoption of FIN 48)                        |                         |   | (678)                        |   | (678)                                    |
| Net earnings   |                         |   | 395,429                      |   | 395,429                                  |
| Other comprehensive income   |                         |   |                              | 13,910  | 13,910                                   |
| Issuance of 1,101 shares for exercise of options, including tax benefit of \$3,352 | 1,101                   | 23,432                                    |                              |   | 24,533                                   |
| Issuance of 22 shares to directors   | 22                      | 695                                       |                              |   | 717                                      |

|   |                   |                   |                     |                  |                     |
|---|-------------------|-------------------|---------------------|------------------|---------------------|
| Issuance of 2,215 shares for debt conversions | 2,215             | (2,215)           |                     |                  |                     |
| Stock-based compensation                      |                   | 11,294            |                     |                  | 11,294              |
| Cash dividends declared, \$0.42 per share     |                   |                   | (47,643)            |                  | (47,643)            |
| <b>Balance at December 31, 2007</b>           | <b>\$ 115,069</b> | <b>\$ 831,419</b> | <b>\$ 1,445,995</b> | <b>\$ 47,882</b> | <b>\$ 2,440,365</b> |

See Notes to Consolidated Financial Statements.

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Table of Contents**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

|   | <b>Years Ended December 31,</b> |                  |                  |
|---|---------------------------------|------------------|------------------|
|   | <b>2007</b>                     | <b>2006</b>      | <b>2005</b>      |
| Cash flows from operating activities:   |                                 |                  |                  |
| Net earnings  | \$ 395,429                      | \$ 342,285       | \$ 191,192       |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                                 |                  |                  |
| Change in premium, claims and other receivables                                     | 97,304                          | 40,955           | (6,094)          |
| Change in reinsurance recoverables  | 213,353                         | 192,049          | (250,829)        |
| Change in ceded unearned premium  | (18,436)                        | 13,291           | 82,433           |
| Change in loss and loss adjustment expense payable                                  | 129,203                         | 136,520          | 705,688          |
| Change in reinsurance balances payable  | 7,002                           | (54,834)         | (49,772)         |
| Change in unearned premium  | 21,498                          | 109,280          | 38,809           |
| Change in premium and claims payable, net of restricted cash                        | (164,977)                       | (126,027)        | (3,851)          |
| Gain on sale of subsidiaries  |                                 |                  | (8,717)          |
| Change in trading portfolio   | 9,362                           | (19,919)         | (66,809)         |
| Depreciation and amortization expense   | 15,982                          | 14,980           | 14,647           |
| Stock-based compensation expense  | 12,011                          | 13,126           | 2,645            |
| Other, net  | 8,705                           | (8,318)          | (25,352)         |
| <b>Cash provided by operating activities</b>  | <b>726,436</b>                  | <b>653,388</b>   | <b>623,990</b>   |
| Cash flows from investing activities:   |                                 |                  |                  |
| Sales of fixed income securities  | 438,057                         | 338,927          | 237,480          |
| Maturity or call of fixed income securities   | 302,876                         | 247,072          | 186,075          |
| Cost of securities acquired   | (1,377,750)                     | (1,389,984)      | (1,054,529)      |
| Change in short-term investments  | (72,279)                        | 129,919          | (72,703)         |
| Sale of strategic investments   | 46,612                          | 63,285           | 14,146           |
| Payments for purchase of subsidiaries, net of cash received                         | (65,112)                        | (45,722)         | (94,056)         |
| Sale of subsidiaries  |                                 |                  | 21,116           |
| Other, net  | (9,741)                         | (11,971)         | (10,509)         |
| <b>Cash used by investing activities</b>  | <b>(737,337)</b>                | <b>(668,474)</b> | <b>(772,980)</b> |
| Cash flows from financing activities:   |                                 |                  |                  |
| Advances on line of credit and issuance of notes payable                            | 232,000                         | 140,000          | 46,528           |
| Payments on line of credit and notes payable  | (205,763)                       | (140,616)        | (48,181)         |
| Sale of common stock, net of costs  | 24,533                          | 18,999           | 186,103          |
| Dividends paid  | (46,158)                        | (38,923)         | (27,644)         |
| Other, net  | (2,866)                         | 9,981            | (3,814)          |
| <b>Cash provided (used) by financing activities</b>                                 | <b>1,746</b>                    | <b>(10,559)</b>  | <b>152,992</b>   |

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|                                 |                  |                  |                  |
|---------------------------------|------------------|------------------|------------------|
| Net increase (decrease) in cash | (9,155)          | (25,645)         | 4,002            |
| Cash at beginning of year       | 48,290           | 73,935           | 69,933           |
| <b>Cash at end of year</b>      | <b>\$ 39,135</b> | <b>\$ 48,290</b> | <b>\$ 73,935</b> |

See Notes to Consolidated Financial Statements.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**(1) General Information and Significant Accounting and Reporting Policies**

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

Our principal domestic insurance companies are Houston Casualty Company, U.S. Specialty Insurance Company, HCC Life Insurance Company, Avemco Insurance Company and American Contractors Indemnity Company. These companies operate throughout the United States with headquarters in Houston, Texas, Atlanta, Georgia, Frederick, Maryland and Los Angeles, California, respectively. All of our principal domestic insurance companies operate on an admitted basis, except Houston Casualty Company, which also insures international risks. Our foreign insurance companies are HCC International Insurance Company, HCC Europe, HCC Reinsurance Company and the London branch of Houston Casualty Company. These companies operate principally from the United Kingdom, Spain and Bermuda. We also participate in two Lloyd's of London syndicates, which are managed by our subsidiary, HCC Underwriting Agency, Ltd. (UK), operating in London, England.

Our underwriting agencies provide underwriting management and claims servicing for insurance and reinsurance companies in specialized lines of business within the property and casualty and group life, accident and health insurance sectors. Our principal domestic agencies are Professional Indemnity Agency, HCC Global Financial Products, Covenant Underwriters, HCC Specialty Underwriters, HCC Indemnity Guaranty Agency, RA&MCO Insurance Services, MultiNational Underwriters, LLC and G.B. Kenrick & Associates. Our agencies operate throughout the United States. Our principal foreign agency is HCC Global Financial Products, with headquarters in Barcelona, Spain.

Our reinsurance and insurance brokers provide brokerage, consulting and other broker services to insurance and reinsurance companies, commercial customers and individuals in the same lines of business as the insurance companies and underwriting agencies operate. Our principal reinsurance brokers are Rattner Mackenzie and HCC Risk Management, operating principally in the United Kingdom, Bermuda and Houston, Texas. Our insurance broker is Continental Underwriters.

***Basis of Presentation***

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. 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.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

***Net Earned Premium, Policy Acquisition Costs and Ceding Commissions***

Substantially all of the property and casualty, surety, and accident and health policies written by our insurance companies qualify as short-duration contracts. We recognize in current earned income the portion of the premium that provides insurance coverage in the period. Written premium, net of reinsurance, is primarily recognized in earnings on a pro rata basis over the term of the related policies. However, for certain policies, written premium is recognized in earnings over the period of risk in proportion to the amount of insurance risk provided. Unearned premium represents the portion of premium written that relates to the unexpired term of coverage. Premium for commercial title insurance and group life policies is recognized in earnings when the premium is due. When the limit under a specific excess of loss reinsurance layer has been exhausted, we effectively expense the remaining premium for that limit and defer and amortize the reinstatement premium over the remaining period of risk.

We defer our direct costs to underwrite insurance policies, less amounts reimbursed by reinsurers, and charge or credit the costs to earnings proportionate with the premium earned. These policy acquisition costs include commissions, taxes, fees, and other direct underwriting costs. Historical and current loss adjustment expense experience and anticipated investment income are considered in determining premium deficiencies and the recoverability of deferred policy acquisition costs.

***Fee and Commission Income***

Fee and commission income in our consolidated statements of earnings includes fee income from our underwriting agencies, commission income from our reinsurance brokers and proceeds from ceded reinsurance (ceding commissions in excess of acquisition costs). When there is no significant future servicing obligation, we recognize fee and commission income from third parties on the later of the effective date of the policy, the date when the premium can be reasonably established, or the date when substantially all services related to the insurance placement have been rendered to the client. We record revenue from profit commissions based on the profitability of business written, calculated using the respective commission formula and actual underwriting results through the date of calculation. Such amounts are adjusted should experience change. When additional services are required, the service revenue is deferred and recognized over the service period. We record an allowance for estimated return commissions that we may be required to pay on the early termination of policies. Proceeds from ceded reinsurance are earned pro rata over the term of the underlying policy.

When our underwriting agencies utilize one of our insurance company subsidiaries as the policy issuing company and the business is reinsured with a third-party reinsurer, we eliminate in consolidation the fee and commission income against the related insurance company's policy acquisition costs and defer the policy acquisition costs of the underwriting agencies.

***Premium, Claims and Other Receivables***

We use the gross method for reporting receivables and payables on brokered transactions. We review the collectibility of our receivables on a current basis and provide an allowance for doubtful accounts if we deem that there are accounts that are doubtful of collection. The allowance was \$6.4 million and \$6.5 million at December 31, 2007 and 2006, respectively. Our estimate of the level of the allowance could change as conditions change in the future.

***Loss and Loss Adjustment Expense Payable***

Loss and loss adjustment expense payable by our insurance companies is based on estimates of payments to be made for reported losses, incurred but not reported losses, and anticipated receipts from salvage and

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

subrogation. Reserves are recorded on an undiscounted basis, except for reserves of acquired companies. The discount on those reserves is not material. Estimates for reported losses are based on all available information, including reports received from ceding companies on assumed business. Estimates for incurred but not reported losses are based both on our experience and the industry's experience. While we believe that amounts included in our consolidated financial statements are adequate, such estimates may be more or less than the amounts ultimately paid when the claims are settled. We continually review the estimates with our actuaries and any changes are reflected in loss and loss adjustment expense in the period of the change.

***Reinsurance***

We record all reinsurance recoverables and ceded unearned premium as assets, and deferred ceding commissions as liabilities. All such amounts are recorded in a manner consistent with the underlying reinsured contracts. We record a reserve for uncollectible reinsurance based on our assessment of reinsurers' credit worthiness, reinsurance contract terms and collectibility. Information utilized to calculate the reserve is subject to change, which could affect the level of the reserve in the future.

***Cash and Short-term Investments***

Cash consists of cash in banks, generally in operating accounts. We classify certificates of deposit and money market funds as short-term investments. Short-term investments are classified as investments in our consolidated balance sheets as they relate principally to our investment activities.

We generally maintain our cash deposits in major banks and invest our short-term funds in institutional money-market funds and short-term financial instruments. These securities typically mature within ninety days and, therefore, bear minimal risk.

Certain fiduciary funds totaling \$213.4 million and \$295.7 million were included in short-term investments and fixed income securities at December 31, 2007 and 2006, respectively. These funds are held by underwriting agencies, reinsurance brokers or surety companies for the benefit of insurance or reinsurance clients. We earn interest, net of expenses, on these funds.

***Restricted Cash and Cash Investments***

Our agencies withhold premium funds for the payment of claims. These funds are shown as restricted cash and cash investments in our consolidated balance sheets. The corresponding liability is included within premium and claims payable in our consolidated balance sheets. These amounts are considered fiduciary funds, and interest earned on these funds accrues to the benefit of the insurance companies from whom the funds were withheld. Therefore, we do not include these amounts as cash in our consolidated statements of cash flows.

***Investments***

All fixed income securities are classified as available for sale and reported at quoted market value, if readily marketable, or at management's estimated fair value, if not readily marketable. The change in unrealized gain or loss

on these securities is recorded as a component of other comprehensive income, net of the related deferred income tax effect. For fixed income securities denominated in currencies other than the U.S. dollar, the change in unrealized gain or loss includes the effect of exchange rate fluctuations. We purchase fixed income securities with the intent to hold to maturity, but they may be available for sale if market conditions warrant or if our investment policies dictate in order to maximize our investment yield.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

For asset-backed and mortgage-backed securities in our fixed income portfolio, we recognize income using a constant effective yield based on anticipated prepayments and the estimated economic life of the securities. When actual prepayments differ significantly from anticipated prepayments, the estimated economic life is recalculated and the remaining unamortized premium or discount is amortized prospectively over the remaining economic life.

Short-term investments and restricted cash investments are carried at cost, which approximates fair value. Other investments include other alternative investments, which are accounted for using the equity method of accounting, and trading securities, which are carried at fair value. The carrying value of our alternative investments and trading securities was \$172.8 million and \$49.1 million, respectively, at December 31, 2007, and \$147.6 million and \$58.5 million, respectively, at December 31, 2006. Changes in carrying value are included in the consolidated statements of earnings in net investment income for other alternative investments and in other operating income for trading securities.

Realized gains or losses are determined on an average cost basis and included in earnings on the trade date. When impairment of the value of an investment is considered other-than-temporary, the decrease in value is reported in earnings as a realized investment loss and a new cost basis is established. Declines in the market value of invested assets below cost are evaluated for other-than-temporary impairment losses on a quarterly basis. Impairment losses for declines in value of fixed income securities below cost attributable to issuer-specific events are based on all relevant facts and circumstances for each investment and are recognized when we deem the impairment other-than-temporary. For fixed income securities with unrealized losses due to market conditions or industry-related events where we have the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary.

***Derivative Financial Instruments***

We have reinsured interests in two long-term mortgage impairment insurance contracts. The exposure with respect to these two contracts is measured based on movement in a specified UK housing index. These insurance contracts qualify as derivative financial instruments, are unhedged and are reported in other assets at fair value, which was \$16.8 million and \$11.2 million at December 31, 2007 and 2006, respectively. We determine fair value based on our estimate of the present value of expected future cash flows, modified to reflect specific contract terms and validated based on current market quotes. Changes in fair value are recorded each period as a component of other operating income in the consolidated statements of earnings.

We have interest rate swap agreements that effectively convert the \$200.0 million outstanding balance on our Revolving Loan Facility from a variable rate to a fixed rate. These agreements are derivative financial instruments and qualify for hedge accounting treatment as cash flow hedges. Changes in fair value of the swap agreements are recorded each period as a component of other comprehensive income, net of the related deferred income tax effect.

***Strategic Investments and Other Operating Income***

Included in other assets are certain strategic investments in insurance-related companies. For any strategic investment in which we own a 20% to 50% equity interest, the investment and income are recorded using the equity method of accounting. The related income is reported in other operating income in the consolidated statements of earnings. We

carry the remaining investments that are marketable at fair value and the remaining investments that are not readily marketable at management's estimate of fair value. We record any interest, dividends and realized gains or losses in other operating income and unrealized gains or losses in other comprehensive income.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

***Goodwill and Intangible Assets***

When we complete a business combination, goodwill is either allocated to the acquired business or, if there are synergies with our other businesses, allocated to the different reporting units based on their respective share of the estimated future cash flows. In our agency segment, the reporting units are individual subsidiaries. In our insurance company segment, the reporting units are either individual subsidiaries or groups of subsidiaries that share common licensing and other characteristics.

To determine the fair value of a reporting unit, we utilize the expected cash flow approach in Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. This approach utilizes estimated future cash flows, probabilities as to occurrence of these cash flows, a risk-free rate of interest and a risk premium for uncertainty in the cash flows. We utilize our budgets and projection of future operations based on historical and expected industry trends to estimate our future cash flows and their probability of occurring as projected.

We assess the impairment of goodwill annually, or sooner if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Based on our latest impairment test, the fair value of each of our reporting units exceeded its carrying amount. Intangible assets not subject to amortization are tested for impairment annually, or sooner if an event occurs or circumstances change that indicate that an intangible asset might be impaired. Other intangible assets are amortized over their respective useful lives.

***Foreign Currency***

The functional currency of some of our foreign subsidiaries and branches is the U.S. dollar. Assets and liabilities recorded in foreign currencies are translated into U.S. dollars at exchange rates in effect at the balance sheet date. For available for sale securities, unrealized gains and losses related to fluctuations in exchange rates are recorded as a component of other comprehensive income, net of the related deferred income tax effect. Transactions in foreign currencies are translated at the rates of exchange in effect on the date the transaction occurs. Transaction gains and losses are recorded in earnings and included in other operating expense in the consolidated statements of earnings. Our foreign currency transactions are principally denominated in British pound sterling and the Euro.

We utilize the Euro and British pound sterling as the functional currency in our other foreign operations. The cumulative translation adjustment, representing the effect of translating these subsidiaries' assets and liabilities into U.S. dollars, is included in the foreign currency translation adjustment, net of the related deferred income tax effect, within accumulated other comprehensive income. The effect of exchange rate changes on cash balances held in foreign currencies was immaterial for all periods presented and is not shown separately in the consolidated statements of cash flows.

***Income Taxes***

We file a consolidated Federal income tax return and include the foreign subsidiaries' income to the extent required by law. Deferred income tax is accounted for using the liability method, which reflects the tax impact of temporary differences between the bases of assets and liabilities for financial reporting purposes and such bases as measured by

tax laws and regulations. We provide a deferred tax liability for un-repatriated earnings of our foreign subsidiaries at prevailing statutory rates when required. Due to our history of earnings, expectations for future earnings, and taxable income in carryback years, we expect to be able to fully realize the benefit of any net deferred tax asset.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

Effective January 1, 2007, we recorded a liability for our uncertain tax positions where we determined it is not more likely than not the tax position will be sustained upon examination by the appropriate tax authority. Changes in the liability for our uncertain tax positions are reflected in income tax expense or goodwill, if related to an acquisition, in the period a new uncertain tax position arises, we change our judgment about the likelihood of uncertainty, the tax issue is settled, or the statute of limitations expires. We report any potential net interest income or expense and penalties related to changes in our uncertain tax positions in our consolidated statements of earnings as interest expense and other operating expense, respectively.

***Stock-Based Compensation***

Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, requires companies to charge the fair value of stock-based compensation to earnings. Effective January 1, 2006, we adopted SFAS 123(R) using the modified prospective method. We are recognizing compensation expense in 2006 and thereafter for all previously granted but unvested stock options as of January 1, 2006, and all options granted after that date. We use the Black-Scholes single option pricing model to determine the fair value of an option on its grant date and expense that value on a straight-line basis over the option's vesting period. In 2005, we accounted for options granted to employees in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. The 2005 consolidated financial statements were not restated to reflect our adoption of SFAS 123(R).

Prior to the adoption of SFAS 123(R), we accounted for stock-based compensation using the intrinsic value method prescribed in APB 25 and related interpretations. Under APB 25, compensation cost was measured as of the date the number of options and exercise price became fixed. The terms of an award were generally fixed on the date of grant, requiring the option to be accounted for as a fixed award. For fixed awards, compensation expense was measured as the excess, if any, of the quoted closing price of our stock at the date of grant over the exercise price of the option granted. Compensation expense for fixed awards, if any, was recognized ratably over the option vesting period using the straight-line single option method.

Prior to 2006, compensation expense for variable awards was recognized in accordance with Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. If the number of options or exercise price was not fixed on the date of grant, the option was accounted for as a variable award until the number of options or the exercise price became fixed, or until the option was exercised, canceled or expired unexercised. For variable awards, intrinsic value was remeasured each period and was equal to the closing price of our stock on the last day of the reporting period less the grant exercise price. As a result, the amount of compensation expense or benefit recognized each period fluctuated based on changes in our closing stock price from the last day of the previous period to the last day of the current period. In cases when our closing stock price did not exceed the recipient's exercise price, no compensation expense resulted.

Prior to 2006, we accounted for modifications to stock options in accordance with APB 25, as subsequently interpreted by FIN No. 44, *Accounting for Certain Transactions Involving Stock Compensation*. Modifications included, but were not limited to, acceleration of vesting, extension of the exercise period following termination of employment, and/or continued vesting while not providing substantive services. Compensation expense for modified awards was recorded in the period of modification for the intrinsic value of the vested portion of the award, including vesting that occurred while not providing substantive services, after the date of modification. The intrinsic value of the

award was the difference between the closing price of our common stock on the date of modification and the recipient's exercise price.

Prior to 2006, stock options issued to non-employees were accounted for in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*, and Emerging Issues Task Force (EITF) Issue

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. Compensation expense for stock options issued to non-employees was valued using the Black-Scholes model and amortized over the option vesting period in accordance with FIN 28.

***Earnings Per Share***

Basic earnings per share is computed by dividing net earnings by the weighted average common shares outstanding during the year. Diluted earnings per share is computed by dividing net earnings by the weighted average common shares outstanding plus the weighted average potential common shares outstanding during the year. Outstanding common stock options, when dilutive, are included in the weighted average potential common shares outstanding. Also included in the weighted average potential common shares outstanding are common shares that would be issued for any premium in excess of the principal amount of our convertible debt. We use the treasury stock method to calculate the dilutive effect of potential common shares outstanding due to options and our convertible debt.

***Large Loss Events***

During 2006 and 2005, we reached agreements with various reinsurers to commute two large reinsurance contracts related to run-off assumed accident and health reinsurance business included in our discontinued lines. We had \$120.2 million in 2006 and \$145.7 million in 2005 of reinsurance recoverables at the date of commutation. In consideration for discounting the recoverables and reassuming the associated loss reserves, we agreed to accept cash payments that were less than the related recoverables. We recorded a pre-tax loss of \$20.2 million in 2006 and \$26.0 million in 2005 related to these commutations, which was included in loss and loss adjustment expense in our insurance company segment. Net earnings were reduced \$13.1 million in 2006 and \$16.9 million in 2005 as a result of these commutations.

During 2005, we incurred catastrophic losses related to three major and two minor hurricanes (collectively, the 2005 hurricanes) and recognized \$89.7 million of pre-tax losses. This amount included \$73.2 million of losses recorded in loss and loss adjustment expense and \$16.5 million for premiums to reinstate our excess of loss reinsurance protection, which reduced net earned premium. The effect of the 2005 hurricanes reduced consolidated and insurance company segment net earnings \$58.2 million in 2005.

***Recent Accounting Pronouncements***

FIN No. 48, *Accounting for Uncertainty in Income Taxes*, became effective January 1, 2007. Under FIN 48, a company may only recognize the tax benefit from an uncertain tax position if it is more likely than not the tax position will be sustained upon examination by the tax authority. See Note 7 for discussion about our adoption of FIN 48.

The FASB has issued SFAS No. 157, *Fair Value Measurements*, which clarifies the definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. The FASB has also issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows a company to measure fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. Unrealized gains and losses for those items are reported in current

earnings at each subsequent reporting date. Both SFAS 157 and SFAS 159 are effective January 1, 2008. We do not expect their adoption to have a material impact on our consolidated financial statements.

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

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

**(2) Acquisitions, Disposition and Goodwill****Acquisitions**

During the past three years, we have completed numerous acquisitions. We acquired these companies to diversify into new specialty lines of business or to grow existing lines of business. The business combinations were recorded using the purchase method of accounting, and the results of operations of the acquired businesses were included in our consolidated financial statements beginning on the effective date of each transaction. The following table provides additional information on these acquisitions (in millions):

|  | <b>Effective Date of Acquisition</b> | <b>Initial Consideration</b> | <b>Goodwill Recognized</b> | <b>Deductible Goodwill</b> |
|--|--------------------------------------|------------------------------|----------------------------|----------------------------|
| United States Surety Company                                       | March 1, 2005                        | \$ 19.4                      | \$ 12.6                    | No                         |
| HCC International Insurance Company                                | July 1, 2005                         | 24.6                         | 17.3                       | No                         |
| Perico Life Insurance Company                                      | November 30, 2005                    | 20.0                         |                            | Yes                        |
| Perico Ltd.  | December 1, 2005                     | 33.4                         | 31.8                       | Yes                        |
| HCCL Holdings Limited (UK) (formerly Illium Insurance Group, Ltd.) | December 31, 2005                    | 3.0                          | 2.1                        | No                         |
| Novia Underwriters, Inc.   | June 30, 2006                        | 5.5                          | 5.2                        | No                         |
| G.B. Kenrick & Associates, Inc.                                    | July 1, 2006                         | 18.0                         | 16.9                       | No                         |
| Health Products Division   | October 2, 2006                      | 140.0                        | 137.2                      | Yes                        |
| Promoregistration.com  | March 2, 2007                        | 4.1                          |                            | Yes                        |
| Pioneer General Insurance Company                                  | November 1, 2007                     | 12.0                         | 4.8                        | No                         |

In the above table, the initial consideration column represents cash and the value of our common stock paid for the acquisition. The goodwill recognized column represents goodwill recorded through December 31, 2007. The deductible goodwill column indicates if the goodwill is deductible for income tax purposes.

On November 1, 2007, we acquired Ponderosa Management Inc., the parent company of Pioneer General Insurance Company, for \$12.0 million in cash. Pioneer General writes surety bonds and its operations are included in our insurance company segment. We valued all identifiable assets and liabilities at fair value and allocated \$4.8 million to goodwill in our initial purchase price allocation. We are currently obtaining additional information to complete our

purchase price allocation, which we expect to complete in the first quarter of 2008.

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

On October 2, 2006, we acquired the Health Products Division of Allianz Life Insurance Company of North America (the Health Products Division) in a purchase business combination for \$140.0 million. In addition, we assumed the Health Products Division's outstanding loss reserves totaling \$149.7 million and net miscellaneous other liabilities of \$0.4 million. Allianz paid us the net amount of \$10.1 million in cash. We acquired the Health Products Division to expand our medical stop-loss line and diversify our business by adding several new medical excess products; to add skilled underwriters and managers with extensive experience with medical stop-loss and medical excess products; to apply our unique synergies to the Health Products Division's business to increase its profitability; and to strengthen our competitive position as a leader in the medical stop-loss and excess lines.

The Health Products Division generated a profit in 2007, and we expect it to continue to generate a profit and positive cash flow due to the unique synergies (specialized systems, claims administration, operational focus and management expertise) our existing medical stop-loss business contributed to the combined, post-acquisition business. For our purchase price allocation, we assessed the value of these synergies, as well as the value of the assembled workforce. The value of these items was subsumed into goodwill in accordance with SFAS No. 141, *Business Combinations*. We valued all identifiable assets and liabilities at fair value, including discounting the loss reserves by \$2.9 million. The following table summarizes the fair value of assets acquired and liabilities assumed and the resulting \$137.2 million of goodwill:

|  |               |
|--|---------------|
| Premium, claims and other receivables        | \$ 6,372      |
| Goodwill                                     | 137,154       |
| Other assets                                 | 280           |
| <br>Total assets acquired                    | <br>143,806   |
| <br>Loss and loss adjustment expense payable | <br>146,811   |
| Reinsurance balances payable                 | 746           |
| Premium and claims payable                   | 4,375         |
| Accounts payable and accrued liabilities     | 1,961         |
| <br>Total liabilities assumed                | <br>153,893   |
| <br>Net cash received                        | <br>\$ 10,087 |

Our prior acquisition of HCC Global Financial Products, LLC on October 1, 2002 for \$6.9 million of initial consideration includes a contingency for earnout payments based on earnings after the acquisition date, as defined in the purchase agreement. The agreement requires us to pay an earnout based on pre-tax earnings on business underwritten by HCC Global from the acquisition date through September 30, 2007, with no maximum amount due to the former owners. The contractual pre-tax earnings include underwriting results on longer-duration business written by HCC Global and, per the agreement, the earnout cannot be finally determined until all future losses are paid. When the conditions for accrual have been satisfied under the purchase agreement, we record a liability to the former owners with an offsetting increase to goodwill. At December 31, 2007, we had accrued earnouts totaling \$31.7 million, of

which \$29.0 million and \$2.7 million will be paid in 2008 and 2009, respectively. The total earnout and the related goodwill recognized from the acquisition date through December 31, 2007 was \$166.3 million.

**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)*****Subsequent Acquisition***

On January 2, 2008, we acquired MultiNational Underwriters, LLC, for \$42.0 million in cash and a possible additional earnout depending upon future underwriting profit levels. This agency writes domestic and international short-term medical insurance.

***Disposition***

The earnings from discontinued operations represents the final earnout payment we received for a business sold in 2003.

***Goodwill***

When we complete a business combination, goodwill is either allocated to the acquired business or, if there are synergies with our other businesses, allocated to the different reporting units based on their respective share of the estimated future cash flows. In 2007, we transferred \$3.3 million of goodwill associated with a strategic investment to the carrying cost of that investment. The changes in goodwill were as follows:

|                                     | <b>Insurance<br/>Company</b> | <b>Agency</b> | <b>Other<br/>Operations</b> | <b>Corporate</b> | <b>Total</b> |
|-------------------------------------|------------------------------|---------------|-----------------------------|------------------|--------------|
| <b>Balance at December 31, 2005</b> | \$ 340,069                   | \$ 192,878    | \$                          | \$               | \$ 532,947   |
| Additions:                          |                              |               |                             |                  |              |
| Acquisitions                        | 151,717                      | 7,005         |                             | 3,323            | 162,045      |
| Earnouts                            | 41,034                       | 6,651         |                             |                  | 47,685       |
| <b>Balance at December 31, 2006</b> | 532,820                      | 206,534       |                             | 3,323            | 742,677      |
| Additions:                          |                              |               |                             |                  |              |
| Acquisitions                        | 3,503                        |               |                             |                  | 3,503        |
| Earnouts                            | 27,984                       | 5,206         |                             |                  | 33,190       |
| Other                               | (323)                        |               | 323                         | (3,323)          | (3,323)      |
| <b>Balance at December 31, 2007</b> | \$ 563,984                   | \$ 211,740    | \$ 323                      | \$               | \$ 776,047   |

Table of Contents**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)****(3) Investments**

Substantially all of our fixed income securities are investment grade and 99% are rated A or better. The cost or amortized cost, gross unrealized gain or loss, and fair value of investments in fixed income securities, all of which are classified as available for sale, were as follows:

|   | <b>Cost or<br/>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gain</b> | <b>Gross<br/>Unrealized<br/>Loss</b> | <b>Fair<br/>Value</b> |
|---|---------------------------------------|--------------------------------------|--------------------------------------|-----------------------|
| <u>December 31, 2007</u>                          |                                       |                                      |                                      |                       |
| U.S. government                                   | \$ 159,147                            | \$ 4,445                             | \$ (9)                               | \$ 163,583            |
| States, municipalities and political subdivisions | 1,802,417                             | 22,494                               | (2,630)                              | 1,822,281             |
| Corporate fixed income securities                 | 299,288                               | 2,778                                | (4,498)                              | 297,568               |
| Asset-backed and mortgage-backed securities       | 1,001,423                             | 12,692                               | (4,423)                              | 1,009,692             |
| Foreign securities                                | 379,392                               | 956                                  | (6,767)                              | 373,581               |
| <b>Total fixed income securities</b>              | <b>\$ 3,641,667</b>                   | <b>\$ 43,365</b>                     | <b>\$ (18,327)</b>                   | <b>\$ 3,666,705</b>   |
| <u>December 31, 2006</u>                          |                                       |                                      |                                      |                       |
| U.S. government                                   | \$ 121,641                            | \$ 689                               | \$ (750)                             | \$ 121,580            |
| States, municipalities and political subdivisions | 1,350,509                             | 16,008                               | (4,815)                              | 1,361,702             |
| Corporate fixed income securities                 | 334,750                               | 765                                  | (4,950)                              | 330,565               |
| Asset-backed and mortgage-backed securities       | 787,838                               | 4,989                                | (6,785)                              | 786,042               |
| Foreign securities                                | 414,080                               | 214                                  | (6,990)                              | 407,304               |
| <b>Total fixed income securities</b>              | <b>\$ 3,008,818</b>                   | <b>\$ 22,665</b>                     | <b>\$ (24,290)</b>                   | <b>\$ 3,007,193</b>   |



**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

All fixed income securities were income producing during 2007, except for one security valued at \$0.4 million. The following table displays the gross unrealized losses and fair value of all investments that were in a continuous unrealized loss position for the periods indicated:

|   | <b>Less than 12 Months<br/>Unrealized</b> |                   | <b>12 Months or More<br/>Unrealized</b> |                    | <b>Total<br/>Unrealized</b> |                    |
|---|---|-------------------|---|--------------------|-----------------------------|--------------------|
|   | <b>Fair<br/>Value</b>                     | <b>Losses</b>     | <b>Fair<br/>Value</b>                   | <b>Losses</b>      | <b>Fair Value</b>           | <b>Losses</b>      |
| <b><u>December 31, 2007</u></b>   |   |                   |   |                    |                             |                    |
| U.S. government<br>States, municipalities and<br>political subdivisions | \$ 671                                    | \$ (2)            | \$ 2,234                                | \$ (7)             | \$ 2,905                    | \$ (9)             |
| Corporate fixed income<br>securities                                    | 236,494                                   | (1,535)           | 149,584                                 | (1,095)            | 386,078                     | (2,630)            |
| Asset-backed and<br>mortgage-backed securities                          | 34,577                                    | (2,316)           | 107,084                                 | (2,182)            | 141,661                     | (4,498)            |
| Foreign securities  | 89,112                                    | (1,205)           | 220,651                                 | (3,218)            | 309,763                     | (4,423)            |
|   | 82,971                                    | (861)             | 217,555                                 | (5,906)            | 300,526                     | (6,767)            |
| <b>Total fixed income<br/>securities</b>                                | <b>\$ 443,825</b>                         | <b>\$ (5,919)</b> | <b>\$ 697,108</b>                       | <b>\$ (12,408)</b> | <b>\$ 1,140,933</b>         | <b>\$ (18,327)</b> |
| <b><u>December 31, 2006</u></b>   |   |                   |   |                    |                             |                    |
| U.S. government<br>States, municipalities and<br>political subdivisions | \$ 6,892                                  | \$ (19)           | \$ 49,922                               | \$ (731)           | \$ 56,814                   | \$ (750)           |
| Corporate fixed income<br>securities                                    | 188,704                                   | (801)             | 239,299                                 | (4,014)            | 428,003                     | (4,815)            |
| Asset-backed and<br>mortgage-backed securities                          | 60,037                                    | (236)             | 194,020                                 | (4,714)            | 254,057                     | (4,950)            |
| Foreign securities  | 207,133                                   | (909)             | 263,886                                 | (5,876)            | 471,019                     | (6,785)            |
|   | 272,668                                   | (4,340)           | 92,152                                  | (2,650)            | 364,820                     | (6,990)            |
| <b>Total fixed income<br/>securities</b>                                | <b>\$ 735,434</b>                         | <b>\$ (6,305)</b> | <b>\$ 839,279</b>                       | <b>\$ (17,985)</b> | <b>\$ 1,574,713</b>         | <b>\$ (24,290)</b> |

We regularly review our investments for possible impairments and assess whether any impairments are other-than-temporary. The determination that a security has incurred an other-than-temporary decline in value and the amount of any current loss recognition requires management judgment and a continual review of market conditions and our investment portfolio. We considered all of the unrealized losses at December 31, 2007 and 2006 shown above to be temporary based on the results of our review. There were no other-than-temporary realized losses on our fixed income securities in 2007 or 2006.



**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

The amortized cost and fair value of our fixed income securities at December 31, 2007, 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 asset-backed and mortgage-backed securities at December 31, 2007 was 5.6 years.

|   | <b>Amortized<br/>Cost</b> | <b>Fair Value</b>   |
|---|---------------------------|---------------------|
| Due in 1 year or less                       | \$ 179,988                | \$ 179,763          |
| Due after 1 year through 5 years            | 755,590                   | 759,231             |
| Due after 5 years through 10 years          | 677,588                   | 682,303             |
| Due after 10 years through 15 years         | 497,485                   | 502,752             |
| Due after 15 years                          | 529,593                   | 532,964             |
| Securities with fixed maturities            | 2,640,244                 | 2,657,013           |
| Asset-backed and mortgage-backed securities | 1,001,423                 | 1,009,692           |
| <b>Total fixed income securities</b>        | <b>\$ 3,641,667</b>       | <b>\$ 3,666,705</b> |

At December 31, 2007, our domestic insurance companies had deposited fixed income securities of \$49.3 million (amortized cost of \$47.7 million) to meet the deposit requirements of various insurance departments. In addition, we had a deposit of fixed income securities of \$23.6 million (amortized cost of \$23.1 million) at Lloyd's of London, which serves as security for our participation in two Lloyd's of London syndicates. There are withdrawal and other restrictions on these deposits, but we direct how the deposits are invested and we earn interest on the funds.

The sources of net investment income were as follows:

|                              | <b>2007</b>       | <b>2006</b>       | <b>2005</b>      |
|------------------------------|-------------------|-------------------|------------------|
| Fixed income securities      | \$ 150,594        | \$ 112,878        | \$ 77,842        |
| Short-term investments       | 37,764            | 30,921            | 21,208           |
| Other investments            | 23,930            | 14,178            | 3,615            |
| Total investment income      | 212,288           | 157,977           | 102,665          |
| Investment expense           | (5,826)           | (5,173)           | (3,814)          |
| <b>Net investment income</b> | <b>\$ 206,462</b> | <b>\$ 152,804</b> | <b>\$ 98,851</b> |



**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

Realized pre-tax gains (losses) on the sale of investments were as follows:

|                                     | <b>Gains</b>     | <b>Losses</b>     | <b>Net</b>       |
|-------------------------------------|------------------|-------------------|------------------|
| <u>Year ended December 31, 2007</u> |                  |                   |                  |
| Fixed income securities             | \$ 14,728        | \$ (1,266)        | \$ 13,462        |
| Other investments                   | 305              | (579)             | (274)            |
| <b>Realized gain (loss)</b>         | <b>\$ 15,033</b> | <b>\$ (1,845)</b> | <b>\$ 13,188</b> |
| <u>Year ended December 31, 2006</u> |                  |                   |                  |
| Fixed income securities             | \$ 886           | \$ (1,771)        | \$ (885)         |
| Other investments                   | 93               | (49)              | 44               |
| <b>Realized gain (loss)</b>         | <b>\$ 979</b>    | <b>\$ (1,820)</b> | <b>\$ (841)</b>  |
| <u>Year ended December 31, 2005</u> |                  |                   |                  |
| Fixed income securities             | \$ 3,562         | \$ (1,475)        | \$ 2,087         |
| Other investments                   | 156              | (795)             | (639)            |
| <b>Realized gain (loss)</b>         | <b>\$ 3,718</b>  | <b>\$ (2,270)</b> | <b>\$ 1,448</b>  |

Since 2005, we used certain available for sale fixed income securities, denominated in British pound sterling, to economically hedge foreign currency exposure on certain insurance reserves and other liabilities, denominated in the same currency. We incorrectly recorded the unrealized exchange rate fluctuations on these securities through earnings as an offset to the opposite fluctuations in the liabilities they hedged, rather than through other comprehensive income within shareholders' equity. In 2007, to correct our accounting, we reversed \$13.4 million of cumulative unrealized exchange rate gains. We recorded this reversal as a charge to our gain or loss from currency conversion account, with an offsetting credit to other comprehensive income. We reported our net loss from currency conversion, which included this \$13.4 million charge, as a component of other operating expense in the consolidated statements of earnings. In 2007, we sold these available for sale securities and realized the \$13.4 million of embedded cumulative currency conversion gains. This gain was included in the net realized investment gain (loss) line of our consolidated statements of earnings. The offsetting effect of these transactions had no impact on our 2007 consolidated net earnings. Our loss from currency conversion, excluding the \$13.4 million charge, was \$1.8 million, zero and \$1.0 million in 2007, 2006 and 2005, respectively.

Unrealized pre-tax net gains (losses) on investments during each year were as follows:

| <b>2007</b> | <b>2006</b> | <b>2005</b> |
|-------------|-------------|-------------|
|-------------|-------------|-------------|

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|   |                 |                 |                    |
|---|-----------------|-----------------|--------------------|
| Fixed income securities                         | \$ 26,663       | \$ 6,890        | \$ (29,265)        |
| Strategic and other investments                 | (22,244)        | (5,063)         | 14,978             |
| <b>Net unrealized investment gains (losses)</b> | <b>\$ 4,419</b> | <b>\$ 1,827</b> | <b>\$ (14,287)</b> |

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)****(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 ceding for reinsurance purposes does not discharge the direct insurer from liability to its policyholder, our insurance companies participate in such agreements in order to limit their loss exposure, protect them against catastrophic loss and diversify their business. The following table presents the effect of such reinsurance transactions on our premium and loss and loss adjustment expense.

|                                     | <b>Written<br/>Premium</b> | <b>Earned<br/>Premium</b> | <b>Loss and Loss<br/>Adjustment<br/>Expense</b> |
|-------------------------------------|----------------------------|---------------------------|---|
| <u>Year ended December 31, 2007</u> |                            |                           |   |
| Direct business                     | \$ 2,000,552               | \$ 2,001,329              | \$ 1,119,384                                    |
| Reinsurance assumed                 | 450,627                    | 433,951                   | 233,026   |
| Reinsurance ceded                   | (465,570)                  | (450,194)                 | (168,463)                                       |
| <b>Net amounts</b>                  | <b>\$ 1,985,609</b>        | <b>\$ 1,985,086</b>       | <b>\$ 1,183,947</b>                             |
| <u>Year ended December 31, 2006</u> |                            |                           |   |
| Direct business                     | \$ 1,867,908               | \$ 1,790,636              | \$ 990,800                                      |
| Reinsurance assumed                 | 367,740                    | 357,799                   | 228,038   |
| Reinsurance ceded                   | (423,096)                  | (439,246)                 | (206,982)                                       |
| <b>Net amounts</b>                  | <b>\$ 1,812,552</b>        | <b>\$ 1,709,189</b>       | <b>\$ 1,011,856</b>                             |
| <u>Year ended December 31, 2005</u> |                            |                           |   |
| Direct business                     | \$ 1,768,284               | \$ 1,694,446              | \$ 1,329,931                                    |
| Reinsurance assumed                 | 270,002                    | 292,944                   | 266,842   |
| Reinsurance ceded                   | (537,062)                  | (617,402)                 | (677,076)                                       |
| <b>Net amounts</b>                  | <b>\$ 1,501,224</b>        | <b>\$ 1,369,988</b>       | <b>\$ 919,697</b>                               |

Ceding commissions netted with policy acquisition costs in the consolidated statements of earnings were \$45.8 million in 2007, \$45.8 million in 2006 and \$96.0 million in 2005.

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

**2007****2006**

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|   |                   |                     |
|---|-------------------|---------------------|
| Commutation receivable                                      | \$                | \$ 100,000          |
| Reinsurance recoverable on paid losses                      | 80,915            | 96,727              |
| Reinsurance recoverable on outstanding losses               | 458,190           | 529,562             |
| Reinsurance recoverable on incurred but not reported losses | 426,090           | 458,528             |
| Reserve for uncollectible reinsurance                       | (8,530)           | (14,883)            |
| <b>Total reinsurance recoverables</b>                       | <b>\$ 956,665</b> | <b>\$ 1,169,934</b> |

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

Our U.S. domiciled insurance companies require reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize their reinsurance obligations due to us. The table below shows the amounts of letters of credit and cash deposits held by us as collateral, plus other credits available for potential offset at December 31, 2007 and 2006.

|                        | <b>2007</b>       | <b>2006</b>       |
|------------------------|-------------------|-------------------|
| Payables to reinsurers | \$ 246,745        | \$ 268,079        |
| Letters of credit      | 188,400           | 326,204           |
| Cash deposits          | 114,549           | 61,002            |
| <b>Total credits</b>   | <b>\$ 549,694</b> | <b>\$ 655,285</b> |

The tables below present the calculation of net reserves, net unearned premium and net deferred policy acquisition costs at December 31, 2007 and 2006.

|   | <b>2007</b>         | <b>2006</b>         |
|---|---------------------|---------------------|
| Loss and loss adjustment expense payable                    | \$ 3,227,080        | \$ 3,097,051        |
| Reinsurance recoverable on outstanding losses               | (458,190)           | (529,562)           |
| Reinsurance recoverable on incurred but not reported losses | (426,090)           | (458,528)           |
| <b>Net reserves</b>   | <b>\$ 2,342,800</b> | <b>\$ 2,108,961</b> |
| Unearned premium  | \$ 943,946          | \$ 920,350          |
| Ceded unearned premium                                      | (244,684)           | (226,125)           |
| <b>Net unearned premium</b>                                 | <b>\$ 699,262</b>   | <b>\$ 694,225</b>   |
| Deferred policy acquisition costs                           | \$ 192,773          | \$ 182,410          |
| Deferred ceding commissions                                 | (68,968)            | (64,949)            |
| <b>Net deferred policy acquisition costs</b>                | <b>\$ 123,805</b>   | <b>\$ 117,461</b>   |

**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

In order to reduce our exposure to reinsurance credit risk, we evaluate the financial condition of our reinsurers and place our reinsurance with a diverse group of companies and syndicates, which we believe to be financially sound. The following table shows reinsurance balances relating to our reinsurers with a net recoverable balance greater than \$25.0 million at December 31, 2007 and 2006. The total recoverables column includes paid losses recoverable, outstanding losses recoverable, incurred but not reported losses recoverable and ceded unearned premium. The total credits column includes letters of credit, cash deposits and other payables.

| <b>Reinsurer</b>                      | <b>Rating</b> | <b>Location</b> | <b>Total Recoverables</b> | <b>Total Credits</b> | <b>Net Recoverables</b> |
|---------------------------------------|---------------|-----------------|---------------------------|----------------------|-------------------------|
| <b>December 31, 2007</b>              |               |                 |                           |                      |                         |
| Hannover Rueckversicherungs AG        | A             | Germany         | \$ 97,224                 | \$ 26,195            | \$ 71,029               |
| Swiss Reinsurance America Corp.       | A+            | New York        | 61,147                    | 3,133                | 58,014                  |
| Harco National Insurance Company      | A-            | Illinois        | 57,679                    | 4,259                | 53,420                  |
| Arch Reinsurance Ltd.                 | A             | Bermuda         | 45,283                    | 2,816                | 42,467                  |
| ACE Property & Casualty Insurance Co. | A+            | Pennsylvania    | 45,450                    | 6,385                | 39,065                  |
| Transatlantic Reinsurance Company     | A+            | New York        | 44,175                    | 9,061                | 35,114                  |
| Everest Reinsurance Company           | A+            | Delaware        | 27,674                    | 70                   | 27,604                  |
| Lloyd s Syndicate Number 2791         | A             | United Kingdom  | 28,518                    | 1,990                | 26,528                  |
| <b>December 31, 2006</b>              |               |                 |                           |                      |                         |
| Hannover Rueckversicherungs AG        | A             | Germany         | \$ 114,715                | \$ 24,833            | \$ 89,882               |
| Arch Reinsurance Ltd.                 | A             | Bermuda         | 55,909                    | 12,771               | 43,138                  |
| Harco National Insurance Company      | A-            | Illinois        | 47,540                    | 6,461                | 41,079                  |
| Swiss Reinsurance America Corp.       | A+            | New York        | 46,828                    | 6,580                | 40,248                  |
| ACE Property & Casualty Insurance Co. | A+            | Pennsylvania    | 42,289                    | 3,885                | 38,404                  |
| Everest Reinsurance Company           | A+            | Delaware        | 51,256                    | 14,833               | 36,423                  |
| Odyssey America Reinsurance Corp.     | A             | Connecticut     | 31,948                    | 869                  | 31,079                  |
| Platinum Underwriters Reinsurance Co. | A             | Maryland        | 31,313                    | 681                  | 30,632                  |

Ratings for companies are published by A.M. Best Company, Inc. Lloyd s of London is an insurance and reinsurance marketplace composed of many independent underwriting syndicates financially supported by a central trust fund. Lloyd s of London is rated A by A.M. Best Company, Inc.

We have a reserve of \$8.5 million at December 31, 2007 for potential collectibility issues related to reinsurance recoverables, including disputed amounts and associated expenses. While we believe the reserve is adequate based on information currently available, market conditions may change or additional information might be obtained that may require us to change the reserve in the future. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

HCC Life Insurance Company previously sold its entire block of individual life insurance and annuity business to Swiss Re Life & Health America, Inc. (rated A+ by A.M. Best Company, Inc.) in the form of an

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

indemnity reinsurance contract. Ceded life and annuity benefits amounted to \$66.2 million and \$70.9 million at December 31, 2007 and 2006, respectively.

**(5) Liability for Unpaid Loss and Loss Adjustment Expense**

The following table provides a reconciliation of the liability for unpaid loss and loss adjustment expense payable.

|   | <b>2007</b>         | <b>2006</b>         | <b>2005</b>         |
|---|---------------------|---------------------|---------------------|
| Reserves for loss and loss adjustment expense payable at beginning of year                            | \$ 3,097,051        | \$ 2,813,720        | \$ 2,089,199        |
| Less reinsurance recoverables   | 988,090             | 1,280,287           | 1,029,916           |
| Net reserves at beginning of year   | 2,108,961           | 1,533,433           | 1,059,283           |
| Net reserve addition from acquired businesses   | 742                 | 146,811             | 12,491              |
| Incurred loss and loss adjustment expense:  |                     |                     |                     |
| Provision for loss and loss adjustment expense for claims occurring in current year                   | 1,210,344           | 1,018,382           | 894,303             |
| Increase (decrease) in estimated loss and loss adjustment expense for claims occurring in prior years | (26,397)            | (6,526)             | 25,394              |
| Incurred loss and loss adjustment expense   | 1,183,947           | 1,011,856           | 919,697             |
| Loss and loss adjustment expense payments for claims occurring during:                                |                     |                     |                     |
| Current year  | 394,754             | 360,803             | 285,814             |
| Prior years   | 556,096             | 222,336             | 172,224             |
| Loss and loss adjustment expense payments   | 950,850             | 583,139             | 458,038             |
| Net reserves at end of year   | 2,342,800           | 2,108,961           | 1,533,433           |
| Plus reinsurance recoverables   | 884,280             | 988,090             | 1,280,287           |
| <b>Reserves for loss and loss adjustment expense at end of year</b>                                   | <b>\$ 3,227,080</b> | <b>\$ 3,097,051</b> | <b>\$ 2,813,720</b> |

Our net loss and loss adjustment expense was impacted by redundant (adverse) reserve development relating to prior years' losses of \$26.4 million in 2007, \$6.5 million in 2006 and \$(25.4) million in 2005. The adverse development for 2005 primarily related to a \$26.0 million commutation charge from our reinsurance on certain run-off assumed accident and health business reported in our discontinued lines. The redundant development for 2006 related to reduction in prior year hurricane reserves and a reduction in aviation reserves, mostly offset by a \$20.2 million commutation charge on the run-off accident and health business. The redundant development for 2007 related

primarily to reserve reductions in our diversified financial products line of business from the 2003 and 2004 underwriting years.

We have no material exposure to asbestos claims or environmental pollution losses. Our largest insurance company subsidiary only began writing business in 1981, and its policies normally contain pollution exclusion clauses that limit pollution coverage to sudden and accidental losses only, thus excluding intentional dumping and seepage claims. Policies issued by our other insurance company subsidiaries do not have significant environmental exposures because of the types of risks covered.

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Table of Contents**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)****(6) Notes Payable**

Notes payable at December 31, 2007 and 2006 are shown in the table below. The aggregate estimated fair value of our 1.30% and 2.00% convertible notes (\$162.4 million and \$436.0 million at December 31, 2007 and 2006, respectively) is based on quoted market prices. The estimated fair value of our Revolving Loan Facility is based on current borrowing rates offered to us and approximates the carrying value at both balance sheet dates.

|   | <b>2007</b>       | <b>2006</b>       |
|---|-------------------|-------------------|
| 1.30% Convertible Notes                 | \$ 124,714        | \$ 124,977        |
| 2.00% Convertible Exchange Notes        |                   | 172,174           |
| \$575.0 million Revolving Loan Facility | 200,000           |                   |
| Other debt                              |                   | 11,736            |
| <b>Total notes payable</b>              | <b>\$ 324,714</b> | <b>\$ 308,887</b> |

Our 1.30% Convertible Notes are due in 2023. We pay interest semi-annually on April 1 and October 1. Each one thousand dollar principal amount of notes is convertible into 44.1501 shares of our common stock, which represents an initial conversion price of \$22.65 per share. The initial conversion price is subject to standard anti-dilution provisions designed to maintain the value of the conversion option in the event we take certain actions with respect to our common stock, such as stock splits, reverse stock splits, stock dividends and extraordinary dividends, that affect all of the holders of our common stock equally and that could have a dilutive effect on the value of the conversion rights of the holders of the notes or that confer a benefit upon our current shareholders not otherwise available to the Convertible Notes. Holders may surrender notes for conversion if, as of the last day of the preceding calendar quarter, the closing sale price of our common stock for at least 20 consecutive trading days during the period of 30 consecutive trading days ending on the last trading day of that quarter is more than 130% (\$29.45 per share) of the conversion price per share of our common stock. We must settle any conversions by paying cash for the principal amount of the notes and issuing our common stock for the value of the conversion premium. We can redeem the notes for cash at any time on or after April 1, 2009. Holders may require us to repurchase the notes on April 1, 2009, 2014 or 2019, or if a change in control of HCC Insurance Holdings, Inc. occurs on or before April 1, 2009. The repurchase price to settle any such put or change in control provisions will equal the principal amount of the notes plus accrued and unpaid interest and will be paid in cash.

In 2007, we announced our intention to redeem the 2% Convertible Exchange Notes, as provided for in the terms of the notes. All notes were surrendered for conversion prior to the redemption date. Each one thousand dollar principal amount was converted into 46.8823 shares of our common stock. We settled the conversions by paying cash for the principal amount of the notes and issuing 2.2 million shares of our common stock for the value of the conversion premium.

Our \$575.0 million Revolving Loan Facility allows us to borrow up to the maximum allowed by the facility on a revolving basis until the facility expires on December 19, 2011. At our option, subject to the lenders' ability to obtain

the necessary commitments, the amount available under the facility may be increased to \$700.0 million. The interest rate is LIBOR plus a margin of 15 to 50 basis points, depending on our debt rating. The facility is collateralized by guarantees entered into by our domestic underwriting agencies and reinsurance brokers. The facility agreement contains certain restrictive covenants, which we believe are typical for similar financing arrangements. At December 31, 2007, the contractual interest rate on the outstanding balance was LIBOR plus 25 basis points (4.85%), but the effective interest rate was 4.6% due to the fixed interest rate swaps discussed below.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

In 2007, we entered into three interest rate swap agreements to exchange LIBOR (4.6% at December 31, 2007) for a 4.6% fixed rate on the \$200.0 million outstanding balance of our Revolving Loan Facility. The swaps mature in November 2009 and qualify for cash flow hedge accounting treatment. At December 31, 2007, the swaps had an unrealized loss of \$2.5 million, which was recorded in other comprehensive income within shareholders' equity.

We have a \$52.0 million Standby Letter of Credit Facility that is used to guarantee our performance in two Lloyds of London syndicates. Letters of credit issued under the Standby Letter of Credit Facility are unsecured commitments of HCC Insurance Holdings, Inc. The Standby Letter of Credit Facility contains standard restrictive covenants similar to our Revolving Loan Facility.

At December 31, 2007, certain of our subsidiaries maintained revolving lines of credit with a bank in the combined maximum amount of \$43.3 million available through November 30, 2009. Advances under the lines of credit are limited to amounts required to fund draws, if any, on letters of credit issued by the bank on behalf of the subsidiaries and short-term direct cash advances. The lines of credit are collateralized by securities having an aggregate market value of up to \$54.1 million, the actual amount of collateral at any one time being 125% of the aggregate amount outstanding. Interest on the lines is payable at the bank's prime rate of interest (7.25% at December 31, 2007) for draws on the letters of credit and either prime or prime less 1% on short-term cash advances. At December 31, 2007, letters of credit totaling \$20.5 million had been issued to insurance companies by the bank on behalf of our subsidiaries, with total securities of \$25.6 million collateralizing the lines.



**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)****(7) Income Taxes**

At December 31, 2007 and 2006, we had current income taxes payable of \$17.3 million and \$4.4 million, respectively, included in accounts payable and accrued liabilities in the consolidated balance sheets.

The following table summarizes the differences between our effective tax rate for financial statement purposes and the Federal statutory rate:

|  | <b>2007</b>       | <b>2006</b>       | <b>2005</b>      |
|--|-------------------|-------------------|------------------|
| Statutory tax rate   | 35%               | 35%               | 35%              |
| Federal tax on continuing operations at statutory rate                           | \$ 205,054        | \$ 178,442        | \$ 95,413        |
| Nontaxable municipal bond interest and dividends received deduction              | (18,215)          | (15,291)          | (12,267)         |
| Non-deductible expenses  | 1,233             | 781               | 1,785            |
| State income taxes, net of federal tax benefit                                   | 3,855             | 3,820             | 3,591            |
| Foreign income taxes   | 37,406            | 22,548            | 15,024           |
| Foreign tax credit   | (37,396)          | (22,405)          | (14,981)         |
| Dividends received deduction on repatriated foreign earnings                     |                   |                   | (2,784)          |
| Uncertain tax positions (net of federal tax benefit on state positions of \$232) | (1,561)           |                   |                  |
| Other, net   | 65                | (346)             | (1,604)          |
| <b>Income tax expense from continuing operations</b>                             | <b>\$ 190,441</b> | <b>\$ 167,549</b> | <b>\$ 84,177</b> |
| <b>Effective tax rate, continuing operations</b>                                 | <b>32.5%</b>      | <b>32.9%</b>      | <b>30.9%</b>     |
| Federal tax on discontinued operations at statutory rate                         | \$                | \$                | \$ 1,556         |
| State income taxes, net of federal tax benefit                                   |                   |                   | 130              |
| Income tax expense on discontinued operations                                    | \$                | \$                | \$ 1,686         |
| Effective tax rate, discontinued operations                                      | %                 | %                 | 37.9%            |
| <b>Total income tax expense</b>  | <b>\$ 190,441</b> | <b>\$ 167,549</b> | <b>\$ 85,863</b> |
| <b>Total effective tax rate</b>  | <b>32.5%</b>      | <b>32.9%</b>      | <b>31.0%</b>     |

**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

The components of income tax expense were as follows:

|  | <b>2007</b>       | <b>2006</b>       | <b>2005</b>      |
|--|-------------------|-------------------|------------------|
| Federal current                                      | \$ 113,950        | \$ 128,167        | \$ 69,113        |
| Federal deferred                                     | 34,948            | 10,957            | (5,485)          |
| Total federal  | 148,898           | 139,124           | 63,628           |
| State current  | 2,795             | 3,842             | 4,266            |
| State deferred                                       | 3,135             | 2,035             | 1,259            |
| Total state  | 5,930             | 5,877             | 5,525            |
| Foreign current                                      | 38,043            | 24,665            | 15,155           |
| Foreign deferred                                     | (637)             | (2,117)           | (131)            |
| Total foreign  | 37,406            | 22,548            | 15,024           |
| Uncertain tax positions                              | (1,793)           |                   |                  |
| <b>Income tax expense from continuing operations</b> | <b>\$ 190,441</b> | <b>\$ 167,549</b> | <b>\$ 84,177</b> |
| Federal current                                      | \$                | \$                | \$ 3,528         |
| Federal deferred                                     |                   |                   | (2,042)          |
| Total federal  |                   |                   | 1,486            |
| State current  |                   |                   | 475              |
| State deferred                                       |                   |                   | (275)            |
| Total state  |                   |                   | 200              |
| Income tax expense from discontinued operations      | \$                | \$                | \$ 1,686         |
| <b>Total income tax expense</b>                      | <b>\$ 190,441</b> | <b>\$ 167,549</b> | <b>\$ 85,863</b> |

**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

The net deferred tax asset is included in other assets in our consolidated balance sheets. The composition of deferred tax assets and liabilities at December 31, 2007 and 2006 was as follows:

|  | <b>2007</b>    | <b>2006</b>      |
|--|----------------|------------------|
| Excess of financial unearned premium over tax                                    | \$ 24,801      | \$ 34,638        |
| Effect of loss reserve discounting and salvage and subrogation accrual for tax   | 58,591         | 48,758           |
| Excess of financial accrued expenses over tax                                    | 8,896          | 9,621            |
| Allowance for bad debts, not deductible for tax                                  | 12,156         | 15,047           |
| Stock option compensation under SFAS 123(R) in excess of deduction for tax       | 6,716          | 4,375            |
| Federal tax net operating loss carryforwards                                     | 650            | 1,087            |
| State tax net operating loss carryforwards                                       | 2,996          | 3,227            |
| Foreign branch net operating loss carryforwards                                  |                | 388              |
| Federal benefit of state uncertain tax positions                                 | 655            |                  |
| Valuation allowance  | (6,521)        | (7,822)          |
| <b>Total deferred tax assets</b>   | <b>108,940</b> | <b>109,319</b>   |
| Unrealized gain on increase in value of securities                               | 22,340         | 20,129           |
| Deferred policy acquisition costs, net of ceding commissions, deductible for tax | 23,025         | 11,432           |
| Amortizable goodwill for tax   | 37,281         | 27,676           |
| Book basis in net assets of foreign subsidiaries in excess of tax                | 15,148         | 17,527           |
| Property and equipment depreciation and other items                              | 10,366         | 8,421            |
| Reimbursement receivable   |                | 2,127            |
| <b>Total deferred tax liabilities</b>  | <b>108,160</b> | <b>87,312</b>    |
| <b>Net deferred tax asset</b>  | <b>\$ 780</b>  | <b>\$ 22,007</b> |

Changes in the valuation allowance account applicable to deferred tax assets result primarily from the acquisition and expiration of net operating losses and other tax attributes related to acquired businesses. In 2005, we eliminated a valuation allowance that we had established when we acquired a subsidiary in 2002. Changes in the valuation allowance were as follows:

|                                       | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|---------------------------------------|-------------|-------------|-------------|
| Balance at beginning of year          | \$ 7,822    | \$ 10,293   | \$ 17,358   |
| Reduction related to 2002 acquisition |             |             | (5,511)     |
| Other                                 | (1,301)     | (2,471)     | (1,554)     |

|                               |          |          |           |
|-------------------------------|----------|----------|-----------|
| <b>Balance at end of year</b> | \$ 6,521 | \$ 7,822 | \$ 10,293 |
|-------------------------------|----------|----------|-----------|

At December 31, 2007, we had Federal and state tax net operating loss carryforwards of approximately \$1.9 million and \$45.3 million, respectively, which will expire in varying amounts through 2027. Future use of certain carryforwards is subject to statutory limitations due to prior changes of ownership. We have recorded valuation allowances of \$0.7 million against our Federal loss carryforwards, substantially all of which would reduce goodwill if the carryforwards are realized, and \$2.7 million against our state loss carryforwards. Based on our history of taxable income in our domestic insurance and other operations and our projections of future

**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

taxable income in our domestic and foreign insurance operations, we believe it is more likely than not that the deferred tax assets related to our loss carryforwards, for which there are no valuation allowances, will be realized.

On January 1, 2007, we adopted FIN No. 48, *Accounting for Uncertainty in Income Taxes*. As a result of adopting FIN 48, our unrecognized gross tax benefits related to uncertain tax positions totaled \$9.9 million and related potential interest totaled \$1.4 million, for which we had previously recorded \$9.2 million of gross tax liabilities on unrecognized tax benefits. To adopt FIN 48 and record the additional required tax and interest liabilities, we reduced beginning retained earnings by \$0.7 million, primarily for potential interest net of the related Federal tax benefit. At December 31, 2007, our unrecognized gross tax benefits totaled \$7.6 million. A reconciliation of our unrecognized gross tax benefits was as follows:

|                                     | <b>2007</b>     |
|-------------------------------------|-----------------|
| Balance at January 1, 2007          | \$ 9,869        |
| Gross increases:                    |                 |
| Tax positions of current year       | 953             |
| Tax positions of prior years        | 248             |
| Acquisitions                        | 72              |
| Gross decreases:                    |                 |
| Statute expirations                 | (1,468)         |
| Settlements                         | (1,327)         |
| Tax positions of prior years        | (305)           |
| Acquisitions                        | (183)           |
| Other                               | (237)           |
| <b>Balance at December 31, 2007</b> | <b>\$ 7,622</b> |

Of the total amount of our unrecognized tax benefits related to uncertain tax positions, \$7.2 million would reduce our annual effective tax rate if the uncertain tax benefits were recognized as a reduction of income tax expense currently. At the date of adoption, it was reasonably possible that the liabilities for our unrecognized tax benefits could decrease \$1.4 million in the subsequent twelve months, mainly due to the expiration of the statute of limitations related to state tax liabilities. At December 31, 2007, it is reasonably possible that liabilities for unrecognized tax benefits could decrease \$0.8 million in the next twelve months, mainly due to the expiration of federal and state statutes of limitation.

We report any potential net interest income and expense and penalties related to changes in our uncertain tax positions in our consolidated statement of earnings as interest expense and other operating expense, respectively. In 2007, we recognized a net \$0.4 million of interest income and no penalties. We had \$1.0 million and \$0.2 million accrued as of December 31, 2007 for interest expense and penalties, respectively.

We file income tax returns in the U.S. Federal jurisdiction, and various states and foreign jurisdictions. With a few exceptions, we are no longer subject to U.S. Federal, state and local, or foreign income tax examinations by tax authorities for years before 2002. In 2007, the Internal Revenue Service commenced an examination of our 2004 and 2005 U.S. income tax returns. We do not expect that the results of this examination will have a material effect on our consolidated financial position, results of operations or cash flows.

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Table of Contents**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)****(8) Shareholders Equity**

In 2007, we granted fully-vested common stock valued at \$80,000 to each non-management director as part of their annual compensation for serving on our Board of Directors. The number of shares granted to each director was based on the closing price on the grant date, which was either the day of the Annual Meeting of Shareholders or the day the director joined the Board, if later. The shares granted had an aggregate fair value of \$0.7 million, which we recognized as compensation expense on the grant date.

In 2005, we sold 4.7 million shares of our common stock in a public offering at a price of \$32.05 per share. Net proceeds from the offering totaled \$150.0 million after deducting the underwriting discount and offering expenses. We used \$108.0 million of the proceeds to make capital contributions to our insurance company subsidiaries and used the remainder for acquisitions.

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

|                                     | <b>Unrealized<br/>Investment<br/>Gain (Loss)</b> | <b>Cash Flow<br/>Hedge<br/>Gain<br/>(Loss)</b> | <b>Foreign<br/>Currency<br/>Translation</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> |
|-------------------------------------|--|--|---|---|
| Balance at December 31, 2004        | \$ 25,781  | \$   | \$ 11,854                                   | \$ 37,635   |
| Net change for year                 | (8,862)  |  | (9,699)                                     | (18,561)  |
| Balance at December 31, 2005        | 16,919   |  | 2,155                                       | 19,074  |
| Net change for year                 | 1,099  |  | 13,799                                      | 14,898  |
| Balance at December 31, 2006        | 18,018   |  | 15,954                                      | 33,972  |
| Net change for year                 | 3,114  | (1,617)  | 12,413                                      | 13,910  |
| <b>Balance at December 31, 2007</b> | <b>\$ 21,132</b>                                 | <b>\$ (1,617)</b>                              | <b>\$ 28,367</b>                            | <b>\$ 47,882</b>  |

U.S. insurance companies are limited to the amount of dividends they can pay to their parent by the laws of their state of domicile. The maximum dividends that our direct domestic subsidiaries can pay in 2008 without special permission is \$160.8 million.

**(9) Earnings Per Share**

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

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|   | <b>2007</b>    | <b>2006</b>    | <b>2005</b>    |
|---|----------------|----------------|----------------|
| Net earnings  | \$ 395,429     | \$ 342,285     | \$ 191,192     |
| Weighted average common shares outstanding  | 112,873        | 111,309        | 105,463        |
| Dilutive effect of outstanding options (determined using the treasury stock method) | 760            | 1,177          | 1,659          |
| Dilutive effect of convertible debt (determined using the treasury stock method)    | 3,364          | 4,250          | 2,315          |
| <b>Weighted average common shares and potential common shares outstanding</b>       | <b>116,997</b> | <b>116,736</b> | <b>109,437</b> |
| Anti-dilutive stock options not included in treasury stock method computation       | 4,714          | 1,588          | 118            |

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(continued, tables in thousands, except per share data)

**(10) Stock-Based Compensation**

Our stock option plans, the 2004 Flexible Incentive Plan and 2001 Flexible Incentive Plan, are administered by the Compensation Committee of the Board of Directors. Options granted under these plans may be used to purchase one share of our common stock. Options vest over a period of up to seven years, which is the requisite service period, and expire four to eight years after grant date.

In 2007, we expensed \$11.3 million (\$7.4 million after-tax or \$0.06 per diluted share) of stock-based compensation, after the effect of the deferral and amortization of related policy acquisition costs. In 2006, we expensed \$13.1 million (\$9.4 million after-tax or \$0.08 per diluted share) on a comparable basis as 2007. At December 31, 2007, there was approximately \$28.8 million of total unrecognized compensation expense related to unvested options that is expected to be recognized over a weighted-average period of 3.0 years. In 2008, we expect to recognize \$11.8 million of expense, including the amortization of deferred policy acquisition costs, related to stock-based compensation for options currently outstanding.

The table below shows the weighted-average fair value of options granted and the related weighted-average assumptions used in the Black-Scholes model, which we use to determine the fair value of an option on its grant date. The risk-free interest rate is based on the U.S. Treasury rate that most closely approximates each option's expected term. We based our expected volatility on the historical volatility of our stock over a period matching each option's expected term. Our dividend yield is based on an average of our historical dividend payments divided by the stock price. We used historical exercise patterns by grant type to estimate the expected option life.

|                               | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|-------------------------------|-------------|-------------|-------------|
| Fair value of options granted | \$ 6.59     | \$ 7.20     | \$ 8.90     |
| Risk free interest rate       | 4.4%        | 4.7%        | 4.0%        |
| Expected volatility           | 21.0%       | 22.0%       | 32.0%       |
| Expected dividend yield       | 1.3%        | 1.1%        | 1.1%        |
| Expected option life          | 4.3 years   | 3.8 years   | 4.8 years   |

The following table details our stock option activity during 2007.

|                                | <b>Number<br/>of Shares</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted-<br/>Average<br/>Contractual<br/>Life</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|--------------------------------|-----------------------------|---|---|--|
| Outstanding, beginning of year | 7,181                       | \$ 22.23  |   |  |
| Granted                        | 2,920                       | 30.91   |   |  |
| Exercised                      | (1,103)                     | 19.28   |   |  |
| Forfeited and expired          | (433)                       | 27.09   |   |  |

|  |       |       |           |           |
|--|-------|-------|-----------|-----------|
| <b>Outstanding, end of period</b>                | 8,565 | 25.79 | 3.5 years | \$ 33,720 |
| <b>Vested or expected to vest, end of period</b> | 7,766 | 25.56 | 3.4 years | 32,056    |
| <b>Exercisable, end of period</b>                | 3,067 | 21.70 | 2.3 years | 22,512    |

The aggregate intrinsic value (the amount by which the fair value of the underlying stock exceeds the exercise price) of options exercised during 2007, 2006 and 2005 was \$12.5 million, \$13.8 million and \$27.9 million, respectively. At December 31, 2007, 10.5 million shares of our common stock were authorized

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

and reserved for the exercise of options and stock grants to directors, of which 8.6 million shares were reserved for options previously granted and 1.9 million shares were reserved for future issuance.

Exercise of options during 2007, 2006 and 2005 resulted in cash receipts of \$21.1 million, \$15.6 million and \$36.1 million, respectively. We generally recognize a tax benefit when our employees exercise options. SFAS 123(R) requires that we report the tax benefit related to the excess of the tax deductible amount over the recognized compensation expense as financing cash flow, rather than as operating cash flow under APB 25. We recorded a \$3.4 million benefit as financing cash flow in 2007 and 2006, and \$6.2 million as operating cash flow in 2005.

In December 2006, we increased the exercise price of all outstanding discounted options held by directors and certain officers to match the closing price of our stock on the actual accounting measurement date, as determined by our stock option investigation. In most cases, these modifications resulted in a lower fair value under the Black-Scholes model. In accordance with the guidance of SFAS 123(R), we will not recognize less expense over the term of the options than the original grant date fair value of these awards. Because the exercise prices were increased, these options are no longer subject to Section 409A of the Internal Revenue Code. Section 409A imposes certain restrictions and additional taxes on recipients of discounted options.

In 2006, certain executives terminated employment and executed agreements to reimburse us for the difference between the actual gain realized from all past option exercises and the gain if mis-priced options had been granted at the closing price of our stock on the actual accounting measurement date as determined by our stock option investigation. We recorded a \$6.1 million receivable related to these contractual reimbursements and a corresponding \$4.0 million increase to additional paid-in capital, net of \$2.1 million of taxes payable on these reimbursements, in 2006. The receivable was collected in 2007.

In August 2007, we completed a tender offer to reprice certain employees' unexercised discounted options and to provide future cash reimbursements for the increase in option price. The offer resulted from our stock option investigation and the potential adverse tax ramifications under Section 409A that might result if the options were not repriced. All employees accepted our offer to reprice their options. The estimated cost of \$4.0 million for the aggregate reimbursements was accrued in 2006. Employees will receive the cash reimbursements as their options vest through 2011. We paid \$2.1 million as the initial payment in January 2008.

In 2007, we paid \$2.1 million to the Internal Revenue Service to cover our employees' personal tax liabilities under Section 409A for options exercised in 2006. This liability was accrued at December 31, 2006. In 2007, we accrued \$0.6 million to cover our employees' personal tax liabilities under Section 409A for options exercised in 2007 before completion of the tender offer and paid this amount to employees in February 2008.

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In 2005, we recorded compensation expense of \$3.0 million, in accordance with APB 25. Prior to adoption of SFAS 123(R), we were required to disclose the effect on net earnings and earnings per share if we had used the fair value method of SFAS No. 123, *Accounting for Stock-Based Compensation*, to value stock options. If we had valued our options using the fair value method under SFAS 123 and the assumptions listed above, the effect on our consolidated financial results would have been as follows:

|   | <b>2005</b> |
|---|-------------|
| Reported net earnings   | \$ 191,192  |
| Stock-based compensation included in reported net earnings, net of income taxes | 2,114       |
| Stock-based compensation using fair value method, net of income taxes           | (8,258)     |
| Pro forma net earnings  | \$ 185,048  |
| Reported basic earnings per share   | \$ 1.81     |
| Fair value stock-based compensation   | (0.06)      |
| Pro forma basic earnings per share  | \$ 1.75     |
| Reported diluted earnings per share   | \$ 1.75     |
| Fair value stock-based compensation   | (0.06)      |
| Pro forma diluted earnings per share  | \$ 1.69     |

**(11) Segment and Geographic Data**

We classify our activities into the following three operating business segments based on services provided:

1) insurance company, 2) agency and 3) other operations. See Note 1 for a description of the principal subsidiaries included in and the services provided by our insurance company and agency segments. Our other operations segment includes insurance-related investments, which we make periodically, and our trading portfolio. Corporate includes general corporate operations and those minor operations not included in a segment. Inter-segment revenue consists primarily of fee and commission income of our agency segment charged to our insurance company segment. Inter-segment pricing (either flat rate fees or as a percentage of premium) approximates what is charged to unrelated parties for similar services. Effective April 1, 2006, we consolidated our London underwriting agency (agency segment) into HCC International Insurance Company (insurance segment).

The performance of each segment is evaluated by our management based on net earnings. Net earnings is calculated after tax and after corporate expense allocations, interest expense on debt incurred at the purchase date, and intercompany eliminations have been charged or credited to our individual segments. All stock-based compensation is included in the corporate segment since it is not included in management's evaluation of the other segments.



**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated.

|  | <b>Insurance<br/>Company</b> | <b>Agency</b>     | <b>Other<br/>Operations</b> | <b>Corporate</b>   | <b>Total</b>        |
|--|------------------------------|-------------------|-----------------------------|--------------------|---------------------|
| <u>Year ended December 31, 2007</u>                      |                              |                   |                             |                    |                     |
| Revenue:   |                              |                   |                             |                    |                     |
| Domestic   | \$ 1,849,620                 | \$ 62,246         | \$ 38,904                   | \$ 4,553           | \$ 1,955,323        |
| Foreign  | 395,495                      | 37,555            |                             |                    | 433,050             |
| Inter-segment  |                              | 78,836            |                             |                    | 78,836              |
| <b>Total segment revenue</b>                             | <b>\$ 2,245,115</b>          | <b>\$ 178,637</b> | <b>\$ 38,904</b>            | <b>\$ 4,553</b>    | <b>2,467,209</b>    |
| Inter-segment eliminations                               |                              |                   |                             |                    | (78,836)            |
| <b>Consolidated total revenue</b>                        |                              |                   |                             |                    | <b>\$ 2,388,373</b> |
| Net earnings (loss):                                     |                              |                   |                             |                    |                     |
| Domestic   | \$ 277,331                   | \$ 29,043         | \$ 22,801                   | \$ (20,168)        | \$ 309,007          |
| Foreign  | 80,502                       | 4,810             |                             |                    | 85,312              |
| <b>Total segment net earnings (loss)</b>                 | <b>\$ 357,833</b>            | <b>\$ 33,853</b>  | <b>\$ 22,801</b>            | <b>\$ (20,168)</b> | <b>394,319</b>      |
| Inter-segment eliminations                               |                              |                   |                             |                    | 1,110               |
| <b>Consolidated net earnings</b>                         |                              |                   |                             |                    | <b>\$ 395,429</b>   |
| Other items:   |                              |                   |                             |                    |                     |
| Net investment income                                    | \$ 192,486                   | \$ 9,520          | \$ 2,498                    | \$ 1,958           | \$ 206,462          |
| Depreciation and amortization                            | 4,921                        | 8,030             | 219                         | 2,812              | 15,982              |
| Interest expense (benefit)                               | 1,579                        | 11,606            | (51)                        | (2,830)            | 10,304              |
| Capital expenditures                                     | 5,462                        | 3,416             | 412                         | 2,780              | 12,070              |
| Income tax expense (benefit)                             | 162,058                      | 25,853            | 13,211                      | (11,531)           | 189,591             |
| Inter-segment eliminations                               |                              |                   |                             |                    | 850                 |
| Consolidated income tax expense on continuing operations |                              |                   |                             |                    | \$ 190,441          |

For 2007, earnings before income taxes were \$453.2 million for our domestic subsidiaries and \$132.7 million for our foreign subsidiaries and branches. During 2007, the corporate segment incurred after-tax expense of \$7.4 million for SFAS 123(R) expense and \$3.8 million for our stock option investigation.

**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(continued, tables in thousands, except per share data)

|  | <b>Insurance<br/>Company</b> | <b>Agency</b>     | <b>Other<br/>Operations</b> | <b>Corporate</b>   | <b>Total</b>        |
|--|------------------------------|-------------------|-----------------------------|--------------------|---------------------|
| <u>Year ended December 31, 2006</u>                      |                              |                   |                             |                    |                     |
| Revenue:   |                              |                   |                             |                    |                     |
| Domestic   | \$ 1,536,675                 | \$ 65,866         | \$ 75,077                   | \$ 6,198           | \$ 1,683,816        |
| Foreign  | 357,092                      | 34,387            |                             |                    | 391,479             |
| Inter-segment  | 25                           | 79,795            |                             |                    | 79,820              |
| <b>Total segment revenue</b>                             | <b>\$ 1,893,792</b>          | <b>\$ 180,048</b> | <b>\$ 75,077</b>            | <b>\$ 6,198</b>    | <b>2,155,115</b>    |
| Inter-segment eliminations                               |                              |                   |                             |                    | (79,820)            |
| <b>Consolidated total revenue</b>                        |                              |                   |                             |                    | <b>\$ 2,075,295</b> |
| Net earnings (loss):                                     |                              |                   |                             |                    |                     |
| Domestic   | \$ 205,024                   | \$ 32,281         | \$ 48,844                   | \$ (20,900)        | \$ 265,249          |
| Foreign  | 66,991                       | 10,038            |                             |                    | 77,029              |
| <b>Total segment net earnings (loss)</b>                 | <b>\$ 272,015</b>            | <b>\$ 42,319</b>  | <b>\$ 48,844</b>            | <b>\$ (20,900)</b> | <b>342,278</b>      |
| Inter-segment eliminations                               |                              |                   |                             |                    | 7                   |
| <b>Consolidated net earnings</b>                         |                              |                   |                             |                    | <b>\$ 342,285</b>   |
| Other items:   |                              |                   |                             |                    |                     |
| Net investment income                                    | \$ 137,896                   | \$ 9,484          | \$ 2,610                    | \$ 2,814           | \$ 152,804          |
| Depreciation and amortization                            | 4,603                        | 7,593             | 509                         | 2,275              | 14,980              |
| Interest expense (benefit)                               | 1,887                        | 11,552            | 517                         | (2,560)            | 11,396              |
| Capital expenditures                                     | 4,199                        | 2,317             | 757                         | 5,731              | 13,004              |
| Income tax expense (benefit)                             | 129,857                      | 25,483            | 23,645                      | (11,262)           | 167,723             |
| Inter-segment eliminations                               |                              |                   |                             |                    | (174)               |
| Consolidated income tax expense on continuing operations |                              |                   |                             |                    | \$ 167,549          |

For 2006, earnings before income taxes were \$393.1 million for our domestic subsidiaries and \$116.7 million for our foreign subsidiaries and branches. During 2006, the insurance company segment recorded an after-tax loss of \$13.1 million due to a commutation, and the corporate segment incurred after-tax expense of \$9.4 million for SFAS 123(R) expense and \$9.3 million for our stock option investigation.





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|   | <b>Insurance<br/>Company</b> | <b>Agency</b>     | <b>Other<br/>Operations</b> | <b>Corporate</b> | <b>Total</b>        |
|---|------------------------------|-------------------|-----------------------------|------------------|---------------------|
| <u>Year ended December 31, 2005</u>                           |                              |                   |                             |                  |                     |
| Revenue:  |                              |                   |                             |                  |                     |
| Domestic  | \$ 1,216,894                 | \$ 62,111         | \$ 35,324                   | \$ 6,784         | \$ 1,321,113        |
| Foreign   | 281,697                      | 39,878            |                             |                  | 321,575             |
| Inter-segment   | 158                          | 86,877            |                             |                  | 87,035              |
| <b>Total segment revenue</b>                                  | <b>\$ 1,498,749</b>          | <b>\$ 188,866</b> | <b>\$ 35,324</b>            | <b>\$ 6,784</b>  | <b>1,729,723</b>    |
| Inter-segment eliminations                                    |                              |                   |                             |                  | (87,035)            |
| <b>Consolidated total revenue</b>                             |                              |                   |                             |                  | <b>\$ 1,642,688</b> |
| Net earnings:   |                              |                   |                             |                  |                     |
| Domestic  | \$ 119,634                   | \$ 31,158         | \$ 22,605                   | \$ 352           | \$ 173,749          |
| Foreign   | 6,488                        | 7,294             |                             |                  | 13,782              |
| <b>Total segment net earnings</b>                             | <b>\$ 126,122</b>            | <b>\$ 38,452</b>  | <b>\$ 22,605</b>            | <b>\$ 352</b>    | <b>187,531</b>      |
| Inter-segment eliminations                                    |                              |                   |                             |                  | 901                 |
| Earnings from discontinued operations,<br>net of income taxes |                              |                   |                             |                  | 2,760               |
| <b>Consolidated net earnings</b>                              |                              |                   |                             |                  | <b>\$ 191,192</b>   |
| Other items:  |                              |                   |                             |                  |                     |
| Net investment income   | \$ 88,397                    | \$ 7,437          | \$ 794                      | \$ 2,223         | \$ 98,851           |
| Depreciation and amortization                                 | 4,825                        | 7,381             | 459                         | 1,982            | 14,647              |
| Interest expense (benefit)                                    | 445                          | 9,173             | 699                         | (2,633)          | 7,684               |
| Capital expenditures  | 2,134                        | 3,046             | 716                         | 4,937            | 10,833              |
| Income tax expense (benefit)                                  | 49,327                       | 26,174            | 10,282                      | (2,034)          | 83,749              |
| Inter-segment eliminations                                    |                              |                   |                             |                  | 428                 |
| Consolidated income tax expense on<br>continuing operations   |                              |                   |                             |                  | \$ 84,177           |

For 2005, earnings before income taxes were \$257.8 million for our domestic subsidiaries (including discontinued operations) and \$19.3 million for our foreign subsidiaries and branches. During 2005, the insurance company segment

recorded after-tax losses of \$58.2 million due to the 2005 hurricanes and \$16.9 million due to a commutation.

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

|                                  | <b>2007</b>         | <b>2006</b>         | <b>2005</b>         |
|----------------------------------|---------------------|---------------------|---------------------|
| Diversified financial products   | \$ 777,414          | \$ 728,861          | \$ 531,136          |
| Group life, accident and health  | 758,516             | 591,070             | 504,382             |
| Aviation                         | 153,121             | 152,886             | 136,197             |
| London market account            | 124,609             | 112,362             | 93,017              |
| Other specialty lines            | 171,824             | 123,981             | 97,721              |
| Discontinued lines               | (398)               | 29                  | 7,535               |
| <b>Net earned premium</b>        | <b>\$ 1,985,086</b> | <b>\$ 1,709,189</b> | <b>\$ 1,369,988</b> |
| Property and casualty            | \$ 121,307          | \$ 114,400          | \$ 113,725          |
| Accident and health              | 18,785              | 22,731              | 18,903              |
| <b>Fee and commission income</b> | <b>\$ 140,092</b>   | <b>\$ 137,131</b>   | <b>\$ 132,628</b>   |

Assets by business segment and geographic location are shown in the following tables.

|                          | <b>Insurance<br/>Company</b> | <b>Agency</b>       | <b>Other<br/>Operations</b> | <b>Corporate</b>  | <b>Total</b>        |
|--------------------------|------------------------------|---------------------|-----------------------------|-------------------|---------------------|
| <u>December 31, 2007</u> |                              |                     |                             |                   |                     |
| Domestic                 | \$ 5,131,724                 | \$ 438,779          | \$ 78,527                   | \$ 298,157        | \$ 5,947,187        |
| Foreign                  | 1,730,569                    | 396,889             |                             |                   | 2,127,458           |
| <b>Total assets</b>      | <b>\$ 6,862,293</b>          | <b>\$ 835,668</b>   | <b>\$ 78,527</b>            | <b>\$ 298,157</b> | <b>\$ 8,074,645</b> |
| <u>December 31, 2006</u> |                              |                     |                             |                   |                     |
| Domestic                 | \$ 4,598,206                 | \$ 499,871          | \$ 135,391                  | \$ 220,665        | \$ 5,454,133        |
| Foreign                  | 1,624,625                    | 551,374             |                             |                   | 2,175,999           |
| <b>Total assets</b>      | <b>\$ 6,222,831</b>          | <b>\$ 1,051,245</b> | <b>\$ 135,391</b>           | <b>\$ 220,665</b> | <b>\$ 7,630,132</b> |

**(12) Commitments and Contingencies****Litigation**

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

We are party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we

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underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes over contractual relationships with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable.

In addition to the litigation discussed above, the following lawsuits related to the outcome of our stock option investigation have been filed:

*Civil Action No. 07-456 (Consolidated); Bacas and Halgren, derivatively on behalf of HCC Insurance Holdings, Inc. v. Way et al.; In the United States District Court for the Southern District of Texas, Houston Division.* This action consolidates all pending derivative suits into one action (*Bacas* suits). The *Bacas* action was filed on February 1, 2007, and the *Halgren* action was filed on February 28, 2007. On February 1, 2008, the parties appeared before the Court to seek approval of a proposed settlement in the case. On April 1, 2008, the Court will hold a final hearing. At the final hearing, we intend to seek final approval of the settlement. Under the terms of the settlement, we have or will implement certain corporate governance reforms. We and our directors and officers liability insurers have agreed to pay up to \$3.0 million to plaintiff's counsel for their attorneys' fees, subject to approval by the Court.

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

In each of these lawsuits, certain of our current and former officers and directors have requested that they be indemnified for any losses and that their legal fees be advanced. Pursuant to our bylaws, our charter, applicable law and certain agreements entered into with some of the defendants, we are currently advancing legal fees.

Although the ultimate outcome of the above matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

***Catastrophe Exposure***

We have exposure to catastrophic losses caused by natural perils (such as hurricanes and earthquakes), as well as from man-made events (such as terrorist attacks). The incidence and severity of catastrophic losses is unpredictable. We assess our exposures in areas most vulnerable to natural catastrophes and apply procedures to ascertain our probable maximum loss from any single event. We maintain reinsurance protection that we believe is sufficient to limit our

exposure to a foreseeable event.

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***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. Other indemnifications agree to reimburse the purchasers for taxes or ERISA-related amounts, if any, assessed after the sale date but related to pre-sale activities. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires on December 31, 2009.

We accrue a loss related to our indemnifications when a valid claim is made by a buyer and we believe we have potential exposure. We currently have several claims under indemnifications that cover certain net losses alleged to have been incurred in periods prior to our sale of certain subsidiaries or otherwise alleged to be covered under indemnification agreements related to such sales. As of December 31, 2007, we have recorded a liability of \$14.8 million and have provided \$5.2 million of letters of credit to cover our obligations or anticipated payments under these indemnifications.

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

***Terrorist Exposure***

Under the Terrorism Risk Insurance Program Reauthorization Act of 2007, we are required to offer terrorism coverage to our commercial policyholders in certain lines of business, for which we may, when warranted, charge an additional premium. The policyholders may or may not accept such coverage. This law establishes a deductible that each insurer would have to meet before U.S. Federal reimbursement would occur. For 2008, our deductible is approximately \$99.8 million. The Federal government would provide reimbursement for 85% of any additional covered losses in 2008 up to the maximum amount set out in the Act. Currently, the Act expires on December 31, 2014.

***Leases***

We lease administrative office facilities and transportation equipment under operating leases that expire at various dates through 2025. The agreements generally require us to pay rent, utilities, real estate taxes, insurance and repairs. We recognize rent expense on a straight-line basis over the term of the lease, including free-rent periods. Rent expense under operating leases totaled \$11.1 million in 2007, \$10.3 million in 2006 and \$9.8 million in 2005.





**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(continued, tables in thousands, except per share data)**

At December 31, 2007, future minimum rental payments required under long-term, non-cancelable operating leases, excluding certain expenses payable by us, were as follows:

|   |                  |
|---|------------------|
| Years ended December 31,                    |                  |
| 2008  | \$ 12,499        |
| 2009  | 11,843           |
| 2010  | 11,124           |
| 2011  | 8,924            |
| 2012  | 6,929            |
| Thereafter                                  | 22,396           |
| <b>Total future minimum rental payments</b> | <b>\$ 73,715</b> |

**(13) Related Party Transactions**

At December 31, 2007, 2006 and 2005, we had accruals of \$31.7 million, \$47.7 million and \$32.3 million, respectively, for amounts owed to former owners of businesses we acquired, who now are officers of certain of our subsidiaries. These accruals represent amounts due under the terms of various acquisition agreements. We paid \$49.0 million in 2007, \$32.3 million in 2006 and \$35.1 million in 2005 related to such agreements.

We own equity interests in three companies for which we use the equity method of accounting. During 2005, we acquired the remaining interest in two other companies we owned a minority interest in and included 100% of their earnings in our consolidated financial statements beginning on the effective date of the acquisitions. We recorded gross written premium from business originating at the five companies (until the acquisition date for the two companies that are now subsidiaries) of \$15.7 million in 2007, \$16.9 million in 2006 and \$40.2 million in 2005. During 2007, 2006 and 2005, we also ceded written premium of \$3.7 million, \$9.3 million and \$8.0 million, respectively, to one of these companies under a quota share reinsurance agreement.

**(14) Statutory Information**

Our insurance companies file financial statements prepared in accordance with statutory accounting principles prescribed or permitted by domestic or foreign insurance regulatory authorities. The differences between statutory financial statements and financial statements prepared in accordance with generally accepted accounting principles vary between domestic and foreign jurisdictions.

Statutory policyholders' surplus and net income, after intercompany eliminations, included in those companies' respective filings with regulatory authorities were as follows:

|             |             |             |
|-------------|-------------|-------------|
| <b>2007</b> | <b>2006</b> | <b>2005</b> |
|-------------|-------------|-------------|

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|                                 |              |              |              |
|---------------------------------|--------------|--------------|--------------|
| Statutory policyholders surplus | \$ 1,744,889 | \$ 1,342,054 | \$ 1,110,268 |
| Statutory net income            | 365,308      | 303,758      | 112,231      |

The 2006 statutory net income was reduced \$13.1 million due to a large commutation. The 2005 statutory net income was reduced \$58.2 million due to the 2005 hurricanes and \$20.3 million due to a large commutation. The statutory surplus of each of our insurance companies is significantly in excess of regulatory risk-based capital requirements.

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**Table of Contents****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(continued, tables in thousands, except per share data)

**(15) Supplemental Information**

Supplemental cash flow information was as follows:

|   | 2007       | 2006      | 2005       |
|---|------------|-----------|------------|
| Cash received from commutations             | \$ 101,040 | \$ 12,750 | \$ 180,789 |
| Income taxes paid                           | 146,829    | 167,086   | 78,309     |
| Interest paid                               | 8,618      | 9,387     | 6,168      |
| Dividends declared but not paid at year end | 12,658     | 11,173    | 8,310      |

The unrealized gain or loss on securities available for sale, deferred taxes related thereto and the issuance of our common stock for the purchase of subsidiaries are non-cash transactions that have been included as direct increases or decreases in our consolidated shareholders' equity.

**(16) Quarterly Financial Data (Unaudited)**

|  | Fourth Quarter |            | Third Quarter |            | Second Quarter |            | First Quarter |            |
|--|----------------|------------|---------------|------------|----------------|------------|---------------|------------|
|  | 2007           | 2006       | 2007          | 2006       | 2007           | 2006       | 2007          | 2006       |
| <b>Total revenue</b>                       | \$ 614,407     | \$ 599,108 | \$ 582,494    | \$ 516,697 | \$ 594,250     | \$ 493,217 | \$ 597,222    | \$ 466,273 |
| <b>Net earnings</b>                        | \$ 99,642      | \$ 80,742  | \$ 97,925     | \$ 93,257  | \$ 101,172     | \$ 89,144  | \$ 96,690     | \$ 79,142  |
| <b>Basic earnings per share data:</b>      |                |            |               |            |                |            |               |            |
| Earnings per share                         | \$ 0.87        | \$ 0.72    | \$ 0.87       | \$ 0.84    | \$ 0.90        | \$ 0.80    | \$ 0.86       | \$ 0.71    |
| <b>Weighted average shares outstanding</b> | 114,641        | 111,635    | 112,652       | 111,359    | 112,273        | 111,218    | 111,959       | 111,014    |
| <b>Diluted earnings per share data:</b>    |                |            |               |            |                |            |               |            |
| Earnings per share                         | \$ 0.85        | \$ 0.69    | \$ 0.84       | \$ 0.80    | \$ 0.86        | \$ 0.76    | \$ 0.83       | \$ 0.68    |
|  | 117,085        | 117,115    | 116,323       | 117,003    | 117,728        | 116,860    | 117,009       | 116,896    |

Weighted  
average shares  
outstanding

During the fourth quarter of 2006, we recorded a \$13.1 million after-tax loss due to a large commutation and \$7.6 million of after-tax expenses related to our stock option investigation.

The sum of earnings per share for the quarters may not equal the annual amounts due to rounding.

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Table of Contents**SCHEDULE 1****HCC INSURANCE HOLDINGS, INC.**

**SUMMARY OF INVESTMENTS  
OTHER THAN INVESTMENTS IN RELATED PARTIES  
(In thousands)**

**December 31, 2007**

| <b>Type of Investment</b>  | <b>Column A</b> | <b>Column B<br/>Cost</b> | <b>Column C<br/>Value</b> | <b>Column D<br/>Amount at<br/>Which<br/>Shown in the<br/>Balance Sheet</b> |
|--|-----------------|--------------------------|---------------------------|--|
| Fixed maturities:  |                 |                          |                           |  |
| Bonds United States government and government agencies and authorities |                 | \$ 159,147               | \$ 163,583                | \$ 163,583   |
| Bonds states, municipalities and political subdivisions                |                 | 716,491                  | 724,305                   | 724,305  |
| Bonds special revenue  |                 | 1,085,926                | 1,097,976                 | 1,097,976  |
| Bonds corporate  |                 | 299,288                  | 297,568                   | 297,568  |
| Asset-backed and mortgage-backed securities                            |                 | 1,001,423                | 1,009,692                 | 1,009,692  |
| Bonds foreign  |                 | 379,392                  | 373,581                   | 373,581  |
| <b>Total fixed maturities</b>  |                 | <b>3,641,667</b>         | <b>\$ 3,666,705</b>       | <b>3,666,705</b>   |
| Equity securities:   |                 |                          |                           |  |
| Common stocks banks, trusts and insurance companies                    |                 | 54,078                   | 61,985                    | 61,985   |
| <b>Total equity securities</b>   |                 | <b>54,078</b>            | <b>\$ 61,985</b>          | <b>61,985</b>  |
| Short-term investments   |                 | 783,650                  |                           | 783,650  |
| Other investments  |                 | 159,937                  |                           | 159,937  |
| <b>Total investments</b>   |                 | <b>\$ 4,639,332</b>      |                           | <b>\$ 4,672,277</b>  |

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Table of Contents**SCHEDULE 2****HCC INSURANCE HOLDINGS, INC.****CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
BALANCE SHEETS  
(in thousands)**

|   | <b>December 31,</b> |                     |
|---|---------------------|---------------------|
|   | <b>2007</b>         | <b>2006</b>         |
| <b>ASSETS</b>                                       |                     |                     |
| Cash  | \$ 440              | \$ 167              |
| Short-term investments                              | 36,479              | 19,892              |
| Investment in subsidiaries                          | 2,596,741           | 2,187,461           |
| Intercompany loans to subsidiaries for acquisitions | 217,041             | 208,008             |
| Receivable from subsidiaries                        | 52,683              | 38,384              |
| Other assets  | 43,122              | 31,088              |
| <b>Total assets</b>                                 | <b>\$ 2,946,506</b> | <b>\$ 2,485,000</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>          |                     |                     |
| Payable to subsidiaries                             | \$ 88,255           | \$ 89,428           |
| Notes payable                                       | 324,714             | 297,151             |
| Deferred Federal income tax                         | 19,059              | 21,205              |
| Accounts payable and accrued liabilities            | 74,113              | 34,413              |
| <b>Total liabilities</b>                            | <b>506,141</b>      | <b>442,197</b>      |
| <b>Total shareholders equity</b>                    | <b>2,440,365</b>    | <b>2,042,803</b>    |
| <b>Total liabilities and shareholders equity</b>    | <b>\$ 2,946,506</b> | <b>\$ 2,485,000</b> |

See Notes to Condensed Financial Information.

Table of Contents**SCHEDULE 2****HCC INSURANCE HOLDINGS, INC.****CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
STATEMENTS OF EARNINGS  
(in thousands)**

|                                    | <b>Years Ended December 31,</b> |                   |                   |
|------------------------------------|---------------------------------|-------------------|-------------------|
|                                    | <b>2007</b>                     | <b>2006</b>       | <b>2005</b>       |
| Equity in earnings of subsidiaries | \$ 401,973                      | \$ 351,657        | \$ 188,202        |
| Interest income from subsidiaries  | 9,345                           | 8,196             | 6,799             |
| Net investment income              | 1,794                           | 2,698             | 2,082             |
| Other operating income (loss)      | (103)                           | 1,130             | 525               |
| <b>Total revenue</b>               | <b>413,009</b>                  | <b>363,681</b>    | <b>197,608</b>    |
| Interest expense                   | 8,950                           | 9,199             | 6,552             |
| Other operating expense            | 12,060                          | 16,172            | 3,404             |
| <b>Total expense</b>               | <b>21,010</b>                   | <b>25,371</b>     | <b>9,956</b>      |
| Earnings before income tax expense | 391,999                         | 338,310           | 187,652           |
| Income tax benefit                 | (3,430)                         | (3,975)           | (3,540)           |
| <b>Net earnings</b>                | <b>\$ 395,429</b>               | <b>\$ 342,285</b> | <b>\$ 191,192</b> |

See Notes to Condensed Financial Information.



Table of Contents**SCHEDULE 2****HCC INSURANCE HOLDINGS, INC.****CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
STATEMENTS OF COMPREHENSIVE INCOME  
(in thousands)**

|   | <b>Years Ended December 31,</b> |                   |                   |
|---|---------------------------------|-------------------|-------------------|
|   | <b>2007</b>                     | <b>2006</b>       | <b>2005</b>       |
| Net earnings  | \$ 395,429                      | \$ 342,285        | \$ 191,192        |
| Other comprehensive income (loss):  |                                 |                   |                   |
| Investment gains (losses):  |                                 |                   |                   |
| Gains (losses) during the year, net of income tax charge (benefit) of \$1,336 in 2007, \$1,373 in 2006 and \$(129) in 2005  | 1,771                           | 2,623             | (239)             |
| Less reclassification adjustment for losses included in net earnings, net of income tax benefit of \$163 in 2006  |                                 | 303               |                   |
| Consolidated subsidiaries investment gains (losses) during the year, net of income tax charge (benefit) of \$13,080 in 2007, \$12,839 in 2006 and \$(2,817) in 2005               | 25,693                          | 23,519            | (4,018)           |
| Less consolidated subsidiaries reclassification adjustment for gains included in net earnings, net of income tax charge of \$13,111 in 2007, \$13,647 in 2006 and \$2,479 in 2005 | (24,350)                        | (25,346)          | (4,605)           |
| Net investment gains (losses)   | 3,114                           | 1,099             | (8,862)           |
| Cash flow hedge loss, net of income tax benefit of \$871  | (1,617)                         |                   |                   |
| Foreign currency translation adjustment, net of income tax charge (benefit) of \$863 in 2007, \$3,249 in 2006 and \$(762) in 2005   | 12,413                          | 13,799            | (9,699)           |
| Other comprehensive income (loss)   | 13,910                          | 14,898            | (18,561)          |
| <b>Comprehensive income</b>   | <b>\$ 409,339</b>               | <b>\$ 357,183</b> | <b>\$ 172,631</b> |

See Notes to Condensed Financial Information.

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Table of Contents**SCHEDULE 2****HCC INSURANCE HOLDINGS, INC.**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
STATEMENTS OF CASH FLOWS  
(in thousands)**

|   | <b>Years Ended December 31,</b> |                 |                  |
|---|---------------------------------|-----------------|------------------|
|   | <b>2007</b>                     | <b>2006</b>     | <b>2005</b>      |
| Cash flows from operating activities:   |                                 |                 |                  |
| Net earnings  | \$ 395,429                      | \$ 342,285      | \$ 191,192       |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                                 |                 |                  |
| Undistributed net income of subsidiaries  | (371,873)                       | (272,409)       | (116,122)        |
| Change in accrued interest receivable added to intercompany loan balances           | (9,345)                         | (7,788)         | (6,712)          |
| Change in accounts payable and accrued liabilities                                  | 18,812                          | 5,788           | (10,999)         |
| Other, net  | (9,254)                         | (2,396)         | 1,414            |
| <b>Cash provided by operating activities</b>  | <b>23,769</b>                   | <b>65,480</b>   | <b>58,773</b>    |
| Cash flows from investing activities:   |                                 |                 |                  |
| Cash contributions to subsidiaries  | (227)                           | (64,299)        | (162,872)        |
| Payments for purchase of subsidiaries, net of cash received                         | (12,021)                        | (23,455)        | (98,829)         |
| Change in short-term investments  | (16,587)                        | 18,290          | (7,176)          |
| Sales and maturities of fixed income securities                                     |                                 | 30,587          | 6,200            |
| Cost of securities acquired   | (912)                           | (10,626)        | (3,400)          |
| Change in receivable/payable from subsidiaries                                      |                                 |                 | 33,303           |
| Intercompany loans to subsidiaries for acquisitions                                 | (52,257)                        | (32,708)        | (39,685)         |
| Payments on intercompany loans to subsidiaries                                      | 52,570                          | 33,461          | 56,610           |
| <b>Cash used by investing activities</b>  | <b>(29,434)</b>                 | <b>(48,750)</b> | <b>(215,849)</b> |
| Cash flows from financing activities:   |                                 |                 |                  |
| Advances on line of credit and issuance of notes payable                            | 232,000                         | 140,000         | 36,000           |
| Payments on line of credit and notes payable  | (204,437)                       | (140,249)       | (36,015)         |
| Sale of common stock, net of costs  | 24,533                          | 18,999          | 186,103          |
| Dividends paid  | (46,158)                        | (38,923)        | (27,644)         |
| <b>Cash provided (used) by financing activities</b>                                 | <b>5,938</b>                    | <b>(20,173)</b> | <b>158,444</b>   |
| Net increase (decrease) in cash   | 273                             | (3,443)         | 1,368            |
| Cash at beginning of year   | 167                             | 3,610           | 2,242            |

|                            |    |     |    |     |    |       |
|----------------------------|----|-----|----|-----|----|-------|
| <b>Cash at end of year</b> | \$ | 440 | \$ | 167 | \$ | 3,610 |
|----------------------------|----|-----|----|-----|----|-------|

See Notes to Condensed Financial Information.

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**HCC INSURANCE HOLDINGS, INC.**

**CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
NOTES TO CONDENSED FINANCIAL INFORMATION**

- (1) The accompanying condensed financial information should be read in conjunction with the consolidated financial statements and the related notes thereto of HCC Insurance Holdings, Inc. and Subsidiaries. Investments in subsidiaries are accounted for using the equity method.
- (2) Intercompany loans to subsidiaries are demand notes issued primarily to fund the cash portion of acquisitions. They bear interest at a rate set by management, which approximates the interest rate charged for similar debt. At December 31, 2007, the interest rate on intercompany loans was 6.75%.
- (3) Other operating expense includes \$5.8 million in 2007 and \$12.0 million in 2006 related to the company's stock option investigation.
- (4) Dividends received from subsidiaries were \$30.1 million, \$79.2 million and \$72.1 million in 2007, 2006 and 2005, respectively.

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## SCHEDULE 3

## HCC INSURANCE HOLDINGS, INC.

SUPPLEMENTARY INSURANCE INFORMATION  
(in thousands)

| Column A   | Column B                                   | Column C<br>(1)  | Column D<br>(1)      | Column F           | Column G<br>(2)             | Column H   | Column I  | Column J<br>(3)                | Column K     |
|------------|--|--|----------------------|--------------------|-----------------------------|--|---|--------------------------------|--------------|
|            | Deferred<br>Policy<br>Acquisition<br>Costs | December 31,<br>Future<br>Policy<br>Benefits,<br>Losses,<br>Claims and<br>Loss<br>Expenses | Unearned<br>Premiums | Premium<br>Revenue | Net<br>Investment<br>Income | Years Ended December 31,<br>Benefits,<br>Claims,<br>Losses and<br>Settlement<br>Expenses | December 31,<br>Amortization<br>of Deferred<br>Policy<br>Acquisition<br>Costs | Other<br>Operating<br>Expenses | Pro<br>W     |
| Company    | \$ 123,805                                 | \$ 3,293,279   | \$ 943,946           | \$ 1,985,086       | \$ 192,487                  | \$ 1,183,947   | \$ 366,610  | \$ 127,942                     | \$ 1,000,000 |
| Operations |  |  |                      |                    | 9,520                       |  |   | 73,518                         |              |
|            |  |  |                      |                    | 2,497                       |  |   | 3,032                          |              |
|            |  |  |                      |                    | 1,958                       |  |   | 37,150                         |              |
|            | \$ 123,805                                 | \$ 3,293,279   | \$ 943,946           | \$ 1,985,086       | \$ 206,462                  | \$ 1,183,947   | \$ 366,610  | \$ 241,642                     | \$ 1,000,000 |
| Company    | \$ 117,461                                 | \$ 3,167,974   | \$ 920,350           | \$ 1,709,189       | \$ 137,896                  | \$ 1,011,856   | \$ 319,885  | \$ 110,438                     | \$ 1,000,000 |
| Operations |  |  |                      |                    | 9,484                       |  |   | 70,151                         |              |
|            |  |  |                      |                    | 2,610                       |  |   | 1,839                          |              |
|            |  |  |                      |                    | 2,814                       |  |   | 39,896                         |              |
|            | \$ 117,461                                 | \$ 3,167,974   | \$ 920,350           | \$ 1,709,189       | \$ 152,804                  | \$ 1,011,856   | \$ 319,885  | \$ 222,324                     | \$ 1,000,000 |
| Company    | \$ 88,367                                  | \$ 2,887,135   | \$ 807,109           | \$ 1,369,988       | \$ 88,397                   | \$ 919,697   | \$ 261,708  | \$ 84,838                      | \$ 1,000,000 |
| Operations |  |  |                      |                    | 7,437                       |  |   | 84,107                         |              |
|            |  |  |                      |                    | 794                         |  |   | 1,732                          |              |
|            |  |  |                      |                    | 2,223                       |  |   | 10,313                         |              |
|            | \$ 88,367                                  | \$ 2,887,135   | \$ 807,109           | \$ 1,369,988       | \$ 98,851                   | \$ 919,697   | \$ 261,708  | \$ 180,990                     | \$ 1,000,000 |

- (1) Columns C and D are shown ignoring the effects of reinsurance.
- (2) Net investment income was allocated to the subsidiary, and therefore the segment, on which the related investment asset was recorded.
- (3) Other operating expenses is after all corporate expense allocations have been charged or credited to the individual segments.

*Note:* Column E is omitted because we have no other policy claims and benefits payable.

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**Table of Contents****SCHEDULE 4****HCC INSURANCE HOLDINGS, INC.****REINSURANCE**  
(in thousands)

| <b>Column A</b>                     | <b>Column B</b> | <b>Column C</b>  | <b>Column D</b>  | <b>Column E</b>   | <b>Column F</b>   |
|-------------------------------------|-----------------|------------------|------------------|-------------------|-------------------|
|                                     | <b>Direct</b>   | <b>Ceded to</b>  | <b>Assumed</b>   | <b>Net Amount</b> | <b>Percent of</b> |
|                                     | <b>Amount</b>   | <b>Other</b>     | <b>from</b>      |                   | <b>Amount</b>     |
|                                     |                 | <b>Companies</b> | <b>Other</b>     |                   | <b>Assumed</b>    |
|                                     |                 |                  | <b>Companies</b> |                   | <b>to Net</b>     |
|                                     |                 |                  |                  |                   | <b>to Net</b>     |
| <u>Year ended December 31, 2007</u> |                 |                  |                  |                   |                   |
| Life insurance in force             | \$ 1,267,547    | \$ 417,479       | \$               | \$ 850,068        | %                 |
| Earned premium:                     |                 |                  |                  |                   |                   |
| Property and liability insurance    | \$ 1,329,889    | \$ 415,699       | \$ 291,592       | \$ 1,205,782      | 24%               |
| Accident and health insurance       | 671,440         | 34,495           | 142,359          | 779,304           | 18%               |
| Total                               | \$ 2,001,329    | \$ 450,194       | \$ 433,951       | \$ 1,985,086      | 22%               |
| <u>Year ended December 31, 2006</u> |                 |                  |                  |                   |                   |
| Life insurance in force             | \$ 1,371,637    | \$ 374,753       | \$               | \$ 996,884        | %                 |
| Earned premium:                     |                 |                  |                  |                   |                   |
| Property and liability insurance    | \$ 1,246,650    | \$ 408,632       | \$ 255,303       | \$ 1,093,321      | 23%               |
| Accident and health insurance       | 543,986         | 30,614           | 102,496          | 615,868           | 17%               |
| Total                               | \$ 1,790,636    | \$ 439,246       | \$ 357,799       | \$ 1,709,189      | 21%               |
| <u>Year ended December 31, 2005</u> |                 |                  |                  |                   |                   |
| Life insurance in force             | \$ 1,359,529    | \$ 404,228       | \$               | \$ 955,301        | %                 |
| Earned premium:                     |                 |                  |                  |                   |                   |
| Property and liability insurance    | \$ 1,116,713    | \$ 546,275       | \$ 266,651       | \$ 837,089        | 32%               |

|                               |              |            |            |              |     |
|-------------------------------|--------------|------------|------------|--------------|-----|
| Accident and health insurance | 577,733      | 71,127     | 26,293     | 532,899      | 5%  |
| Total                         | \$ 1,694,446 | \$ 617,402 | \$ 292,944 | \$ 1,369,988 | 21% |

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Table of Contents**SCHEDULE 5****HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES****VALUATION AND QUALIFYING ACCOUNTS**  
(in thousands)

|   | <b>2007</b>     | <b>2006</b>      | <b>2005</b>      |
|---|-----------------|------------------|------------------|
| Reserve for uncollectible reinsurance:        |                 |                  |                  |
| Balance at beginning of year                  | \$ 14,883       | \$ 12,141        | \$ 20,425        |
| Provision charged to expense                  | 2,231           | 5,649            | 5,750            |
| Reclassification to indemnification liability |                 |                  | (9,000)          |
| Amounts written off                           | (8,584)         | (2,907)          | (5,034)          |
| <b>Balance at end of year</b>                 | <b>\$ 8,530</b> | <b>\$ 14,883</b> | <b>\$ 12,141</b> |
| Allowance for doubtful accounts:              |                 |                  |                  |
| Balance at beginning of year                  | \$ 6,514        | \$ 7,394         | \$ 4,911         |
| Provision charged to expense                  | 1,124           | 576              | 1,917            |
| Amounts (written off) recovered and other     | (1,251)         | (1,456)          | 566              |
| <b>Balance at end of year</b>                 | <b>\$ 6,387</b> | <b>\$ 6,514</b>  | <b>\$ 7,394</b>  |

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