

Property/Casualty,
Life Insurers
U.S. and Canada
Credit Analysis

HCC Insurance Holdings, Inc.
And Insurance Subsidiaries

Ratings

Security Class	
Long-Term IDR	A+
Senior Unsecured Debt	A
Houston Casualty Co.	
Avemco Insurance Co.	
U.S. Specialty Insurance Co.	
HCC Life Insurance Co.	
HCC Specialty Insurance Co.	
Insurer Financial Strength	AA

Outlook

Stable

Financial Data

HCC Insurance Holdings, Inc.		
	Date	\$ Mil.
Net Income	9/30/08	232.5
Equity	9/30/08	2,547.5
Debt and Hybrids	9/30/08	374.7
Operating ROAE (%)	9/30/08	13.1
Prism Score	12/31/07	AAA

Analysts

Tana M. Higman
+1 312 368-3122
tana.higman@fitchratings.com

James B. Auden, CFA
+1 312 368-3146
jim.auden@fitchratings.com

Related Research

- *Property/Casualty Insurers' Nine-Month 2008 Results Review, Special Report, Nov. 21, 2008*
- *Property/Casualty Insurers' Financial Leverage and Debt-Servicing Capacity, June 13, 2008*
- *Subprime Mortgage Exposure for Property/Casualty Insurers, April 9, 2008*

Rating Rationale

- Leading market position in a number of narrowly defined, non-correlated specialty insurance segments.
- Underwriting discipline throughout pricing cycles as well as an ability to select and integrate acquisitions, as evidenced by an average combined ratio of approximately 90% from 1991–2007. Through the first nine months of 2008, HCC Insurance Holdings, Inc. (HCC) had a GAAP combined ratio of 85.3%, well below the industry average.
- Significant earnings and cash flow diversity from its operations in insurance underwriting and fee-based insurance intermediary businesses as well as a unique approach to managing underwriting risk that has proven successful over an extended period.
- Conservative investment portfolio focused on high-quality fixed-income securities. Fitch Ratings believes HCC's exposure to the current volatile credit market is less than its peers'. In fact, HCC had a modest increase in shareholders' equity through Sept. 30, 2008.
- Strong capitalization at the operating company level. Based on Fitch's economic capital model, Prism, HCC insurance subsidiaries exceeded Fitch's standards of confidence for the 'AAA' level.
- Reduced reinsurance credit risk in recent years as a result of its growth in underwriting capacity as well as its commutation of reinsurance contracts. Reinsurance recoverables as a percentage of GAAP equity declined to 39% at year-end 2007 from 57% at year-end 2006.

Key Rating Drivers

- Fitch expects HCC to continue to report favorable operating profits in 2008, albeit down from recent record levels due to soft market conditions and investment losses. Should there be operating performance that trails comparably rated peers or a large decline in capitalization at the operating subsidiaries in the future, there could be negative pressure on the ratings.
- Fitch expects HCC to continue to seek opportunities for growth through acquisitions, mainly focusing on underwriting agencies and smaller, niche underwriters. If HCC were to make a major acquisition that significantly increases its financial leverage, Fitch would reevaluate the ratings and Rating Outlook.
- While HCC has exposure to directors and officers (D&O) and errors and omissions (E&O) claims from the subprime mortgage market meltdown, Fitch believes it is manageable and will not result in a significant uptick in the company's loss ratio.

HCC's return on common equity (ROE) averaged 15.4% between 2003 and 2007. Through the first nine months of 2008 the company's ROE was 12.4%.

Consolidated GAAP Operating Performance

(\$ Mil.)

	9M08	2007	2006	2005	2004	2003
Net Premium Written	1,556	1,986	1,813	1,501	1,106	866
% Change in Net Premium Written	3.7	9.5	20.7	35.8	27.7	58.5
Premiums Earned	1,505	1,985	1,709	1,370	1,011	738
Fee and Commission Income	100	140	137	133	184	143
Net Investment Income	131	206	153	99	65	47
Realized Gains	(19)	13	(1)	1	6	1
Income Before Taxes	336	586	510	277	247	228
Net Income	232	395	342	191	163	142

Source: Company financial statements.

Key Rating Issues

Unique business model with profitable track record

HCC's underwriting operations focus on several narrowly defined, non-correlated specialty property/casualty insurance lines and fee-based business through owned insurance agencies and insurance intermediaries. Fitch believes the company's underwriting expertise in its chosen specialty segments and operating flexibility are evidenced by its above-average operating results over the long term. Additionally, the fee-based businesses of HCC's agency operations have provided a unique source of profit and cash flow for HCC. Overall, Fitch believes HCC has a more diversified, non-regulated cash flow and earnings stream than most property/casualty companies, particularly of the same size.

HCC has experienced strong revenue growth in the last several years as a result of its acquisitions and organic growth coupled with less reliance on reinsurance. Net earned premiums have increased at a five-year compound annual growth rate of 31%. Fee and commission income peaked at \$184 million in 2004 and declined to \$140 million in 2007 due to increased premium retention by the insurance company subsidiaries as well as the consolidation of one of HCC's largest underwriting agencies into its life insurance company. However, these changes resulted in increased underwriting revenue in the insurance company subsidiaries. Going forward, management expects fee and commission revenue will grow as the company remains focused on expanding that aspect of its operations.

HCC has traditionally generated underwriting results that are considerably better than industry norms. The company's 15-year average combined ratio on a GAAP basis from 1993–2007 was 89.2% and during that time HCC had a combined ratio over 100% only twice: in 1999 due to reinsurance write-offs and in 2001 due to net losses of \$35.0 million related to the events of Sept. 11, 2001, and a \$37.3 million charge primarily related to the discontinuance of the workers' compensation line of business.

HCC's five-year average combined ratio on a statutory basis of 87.3% compares favorably with the industry average of 97.5%.

GAAP Property/Casualty Underwriting Ratios

(%)

	9M08	2007	2006	2005	2004	2003
Loss Ratio	61.2	59.6	59.2	67.1	63.8	66.1
Expense Ratio	24.1	23.8	25.0	26.1	26.7	24.6
Combined Ratio	85.3	83.4	84.2	93.2	90.5	90.7

Source: Company financial statements.

Net earned premiums have increased at a five-year compound annual growth rate of 31%.

Segment Underwriting Results

(\$ Mil.)

	9M08	2007	2006	2005	2004	2003
Net Earned Premium						
Diversified Financial Products	593.4	777.4	728.9	531.1	310.8	123.6
Group Life, A&H	582.2	758.5	591.1	504.4	343.9	290.0
Aviation	105.1	153.1	152.9	136.2	127.2	97.5
London Market	80.8	124.6	112.4	93.0	111.3	137.6
Other Specialty Lines	138.8	171.8	124.0	97.7	69.1	12.4
Discontinued Lines	4.8	(0.4)	0.0	7.5	48.3	77.2
Total Earned Premium	1,505.1	1,985.1	1,709.2	1,370.0	1,010.7	738.3
GAAP Segment Loss Ratios (%)						
Diversified Financial Products	46.2	40.6	48.2	48.1	47.6	47.8
Group Life, A&H	73.7	76.4	73.1	71.6	66.7	61.6
Aviation	64.7	58.6	53.8	67.3	63.2	61.5
London Market	54.4	55.2	43.0	106.0	65.9	52.8
Other Specialty Lines	73.7	67.4	56.0	72.6	63.5	62.1
Discontinued Lines	NM	NM	NM	551.3	145.2	142.6
Total Loss Ratio	61.2	59.6	59.2	67.1	63.8	66.1

A&H – Accident and health. NM – Not meaningful.

Source: Company financial statements.

HCC incurred \$89.9 million of pretax gross losses and \$24.5 million of pretax net losses related to hurricanes Ike and Gustav in 2008, which added 1.7 points to the combined ratio. Results for 2005 were negatively impacted by pretax net catastrophe losses of \$89.7 million, or 8.2 points. Results for 2004 were marred by approximately \$33.1 million of losses, or 3.2 points, related to the four hurricanes that struck Florida and the Southeastern U.S.

During the past few years, HCC has been opportunistically commuting certain reinsurance contracts, primarily related to its discontinued assumed accident and health business. During 2005 and 2006, HCC reached agreements with various reinsurers to commute two large contracts and as a result recorded pretax losses of \$26 million, or 1.9 points on the combined ratio, in 2005 and \$20.2 million, or 1.2 points on the combined ratio, in 2006.

Fitch believes that while HCC's combined ratio will increase and net income will decline reflective of a soft pricing environment, the company's underwriting expertise and focus on niche products should enable it to continue to produce results better than its peers'.

Solid Capitalization

Based on results from Fitch's economic capital model, Prism, as well as traditional measures of capitalization, Fitch believes HCC's insurance subsidiaries are adequately capitalized. Under Prism, HCC's capital exceeds our standards of confidence for an 'AAA' level at year-end 2007 and 2006. HCC's Prism score benefits from producing regular underwriting profits and below-average volatility in both underwriting performance and loss reserves.

Consolidated policyholders' surplus (PHS) has tripled since 2003, totaling \$1.6 billion at Sept. 30, 2008. This growth has been primarily driven by strong net income with the majority retained at the insurance company level. The company's dividend payout ratio has been 25% over the past five years. Additionally, HCC has contributed \$300 million of capital to its insurance subsidiaries since 2003 to support future growth. The NAIC risk-based capital ratio for Houston Casualty, the lead insurer in the group, was 245% of the company action level at year-end 2007.

PHS has tripled over the past five years as a result of strong levels of retained earnings and the infusion of \$300 million of capital from the parent company since 2003 to support future growth.

Statutory Capital Position

(\$ Mil.)

	2007	2006	2005	2004	2003
Policyholders Surplus (PHS)	1,472	1,118	966	761	518
Net Premium Written/PHS (x)	0.66	0.89	0.96	1.06	1.18
Net Leverage (x)	2.34	3.03	3.09	3.00	3.32
Gross Leverage (x)	3.17	4.26	5.03	5.47	6.45
NAIC Risk-Based Capital Ratio	—	—	—	—	—
% of Company Action Level	245	226	210	257	331

Note: U.S. property and casualty subsidiaries only. Risk-based capital ratio is Houston Casualty Company. Source: Combined statutory financial statements.

Net written premiums to policyholders' surplus for the consolidated U.S. property/casualty operation was 0.8 times (x) at Sept. 30, 2008, up from 0.7x at year-end 2007 and down from 0.9x in 2006. Net leverage (defined as net written premiums plus net liabilities over PHS) decreased slightly to 2.3x in 2007 from 3.0x in 2006. Gross leverage (gross written premiums plus gross liabilities over PHS) has historically been above industry norms due to greater use of ceded reinsurance. However, gross leverage declined to 3.2x in 2007 from 6.5x in 2003 as the company has increased its retention.

Conservative Investment Portfolio

Fitch believes HCC maintains a conservative investment portfolio with the majority of assets invested in fixed-income securities and a below-average exposure to topical assets.

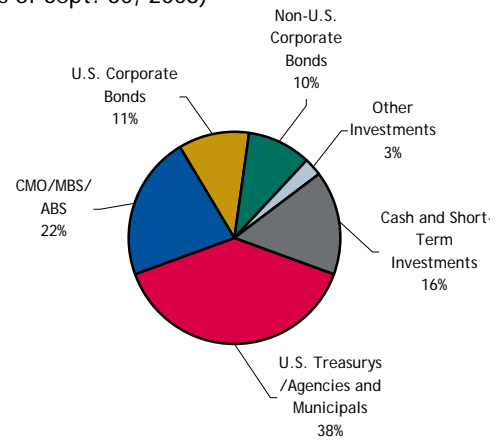
The company currently has no direct exposure to equities after discontinuing the active trading of securities in late 2006 and selling the remaining positions in 2008. During the third quarter of 2008, HCC notified its fund managers of its intention to liquidate all of its alternative investments, primarily fund-of-fund hedge fund investments. At Sept. 30, 2008 the market value of these funds was \$133.5 million. The portfolio will be liquidated in January 2009 with the proceeds reinvested in fixed-income securities.

Fixed-income investments are concentrated in tax-exempt municipal and revenue securities, asset-backed and mortgage-backed securities, foreign corporate securities and U.S. corporate bonds. The average quality of the fixed-income investment portfolio was rated 'AA+' at Sept. 30, 2008.

Cash and invested assets totaled \$4.8 billion at Sept. 30, 2008, up 3% from \$4.7 billion at year-end 2007.

Portfolio Composition

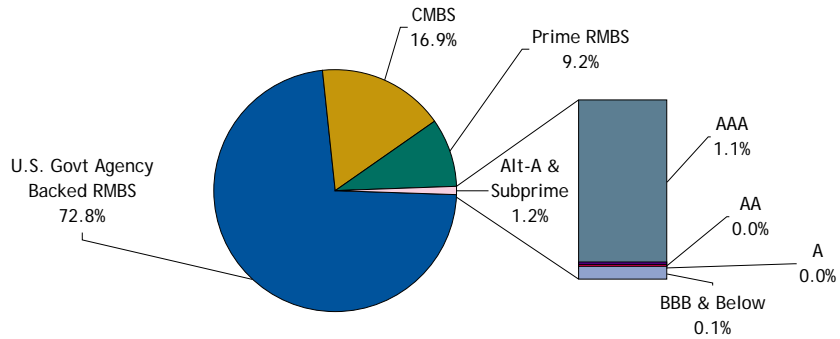
(As of Sept. 30, 2008)



Source: HCC form 10-Q filing.

HCC has a modest \$11.5 million of Alt-A and subprime securities but does not own collateralized debt obligations, collateralized loan obligations or auction rate securities.

MBS and CMO Portfolio
(Totalled \$979 Mil., as of Sept. 30, 2008)



Source: HCC 10-Q filing.

As the duration of HCC's insurance liabilities has crept upward due to its increased writings of longer-tail lines of business, the maturity of its asset portfolio has also increased. At year-end 2007 the weighted-average maturity of the bond portfolio was 6.9 years and the weighted-average duration was 5.1 years, while the weighted-average claims liability duration was under 3.0 years.

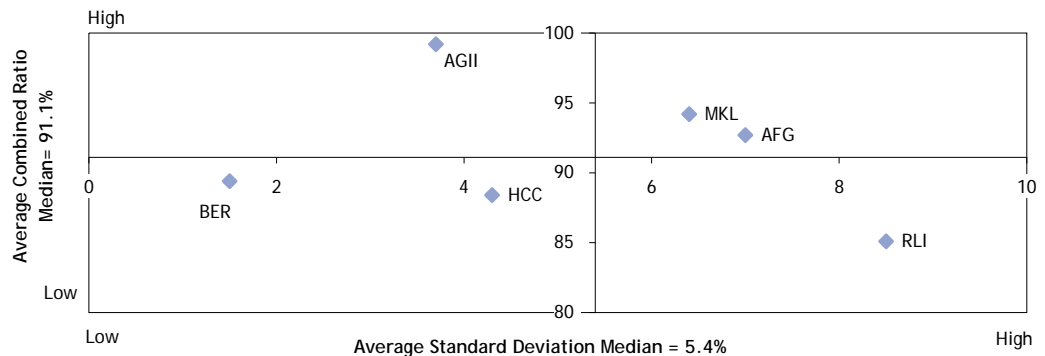
The company recognized \$18.8 million of realized investment losses thus far in 2008, including other-than-temporary impairments (OTTI) of \$6.0 million. The net unrealized loss on the fixed-income portfolio was \$140 million at Oct. 31, 2008, up from \$98 million at Sept. 30, 2008. While all insurers remain exposed to volatile credit market conditions, Fitch believes HCC's focus on high-quality fixed-income securities should enable the company to withstand continued market turmoil without suffering significant reductions in capital.

Peer Analysis

Fitch views HCC's closest peers as pure specialty and excess and surplus lines (E&S) writers such as Argonaut Insurance Company, Markel Corporation, W.R. Berkley Corp., RLI Corp. and American Financial Group, Inc. Additionally, HCC faces competition from Lloyd's of London, as well as large multi-line carriers such as American International

HCC's GAAP combined ratio of 85.3% in the first nine months of 2008 is roughly 5 points lower than its peers'.

Combined Ratio Analysis 2003–2007



Source: SEC Form 10-K.

Group, Inc. (AIG), ACE Limited, XL Capital Ltd., The Chubb Corporation and Travelers Property Casualty Corp. HCC faces competition from UnitedHealth Group, Inc., Symetra Financial Corp. and Hartford Life Insurance Co. in its group life, accident and health business. Fitch views HCC's market share and competitive positioning as comparable to that of its peers'.

HCC's profitability in the recent hard market period of 2003–2007 has been better and less volatile than its peers'. Additionally, HCC has outperformed its specialty lines peers across pricing cycles as evidenced by an average combined ratio of 90% from 1991–2007, or roughly 10 points lower than the peer average. Over that period HCC underperformed its peers in only one year: 1999.

HCC has continued to outperform its specialty lines peers during the first nine months of 2008. The company's solid underwriting results coupled with a lower level of investment losses relative to peers enabled the company to produce an above-average return on equity. Additionally, HCC was the only company within this universe to increase shareholders' equity during the first nine months of 2008.

Peer Results

(%, Year-to-Date Sept. 30, 2008)

	LR	ER	CR	Reserve Development/ EP	Cat Losses /EP	CR Ex-Cats and Development	Operating ROE	Net Income ROE	YTD Change in GAAP Equity
HCC	61.2	24.1	85.3	(3.9)	1.7	87.5	13.1	12.4	4.4
Argo Group	65.3	35.8	101.1	(3.3)	9.5	94.9	6.1	5.0	(2.5)
RLI	47.6	37.6	85.2	(10.7)	6.0	89.9	14.4	12.9	(7.2)
American Financial Group	56.4	31.3	87.7	(8.7)	3.1	93.4	15.8	7.2	(8.8)
Markel	67.7	36.3	104.0	(6.5)	7.6	102.9	5.6	(1.4)	(12.4)
W.R. Berkley	63.2	30.0	93.2	(4.8)	1.9	96.1	16.5	9.7	(14.5)

LR – Loss ratio. ER – Expense ratio. CR – Combined ratio. Cat – Catastrophe. EP – Earned premium. ROE – Return on equity.
Source: 10-Q filings with SEC.

Fitch views HCC's statutory capitalization as more conservative than its peers'.

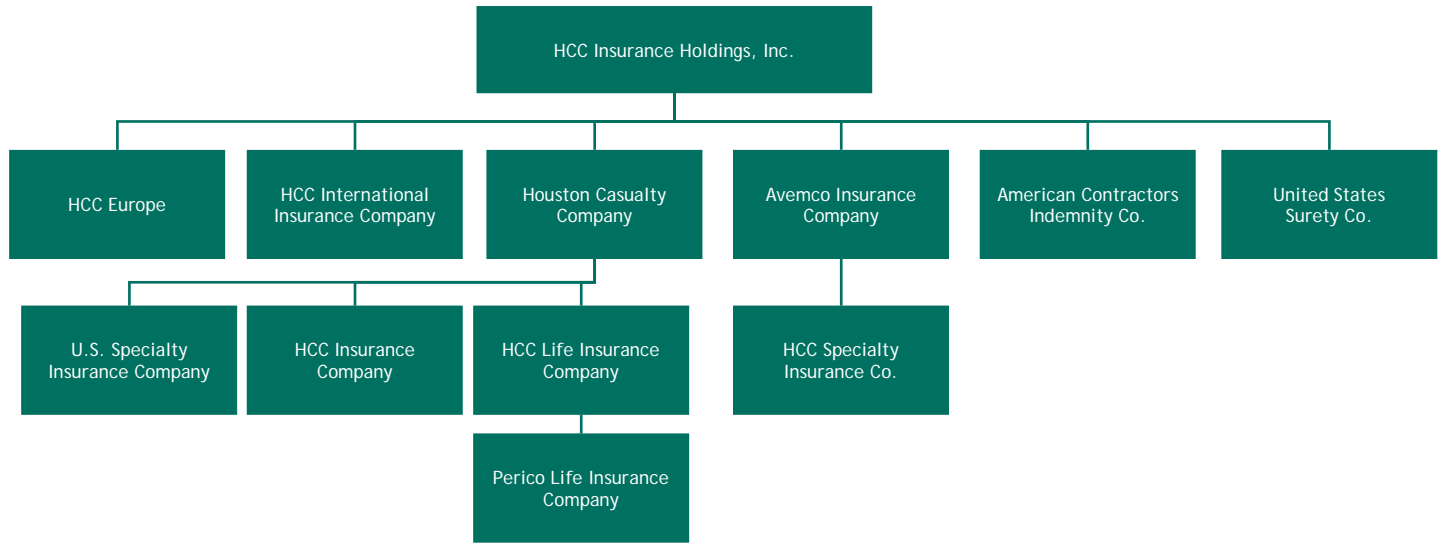
Statutory Capitalization

(As of Dec. 31, 2007)

	IFS	RBC (%)	NPW/PHS (x)	Net Leverage (x)	Gross Leverage (x)
HCC	AA	245	0.7	2.3	3.2
American Financial Group	A+	183	1.2	4.0	5.6
RLI	A	471	0.7	2.3	3.1
Markel	A	196	1.1	3.7	4.4
W.R. Berkley	A	167	1.2	4.0	5.4
Argonaut	BBBq	256	0.8	3.3	4.4

IFS – Insurer financial strength. RBC – Risk-based capital ratio for primary property/casualty subsidiary. NPW – Net premium written. PHS – Policyholder surplus.
Source: Statutory filings with NAIC.

Simplified Organizational Structure



Source: HCC.

Company Profile

Ownership Structure

HCC is a specialty insurance group formed in 1974 and based in Houston. The company is traded on the New York Stock Exchange (NYSE) and had a market capitalization of \$2.5 billion as of Nov. 11, 2008.

For GAAP reporting purposes, HCC operates in two broad segments: insurance and agency operations. For full-year 2007, HCC’s consolidated GAAP revenues, excluding intersegment revenues, were divided approximately 94% insurance operations, 4% underwriting agency and brokerage operations, and 2% corporate and other. Approximately 44% of agency revenues are derived from intersegment sources.

Property/casualty insurance operations are led by Houston Casualty Company (Houston Casualty), a surplus lines underwriter domiciled in Texas. There are six other domestic property/casualty insurers owned by HCC. The company also owns two modest-sized life insurers: HCC Life Insurance Company, which is a wholly owned subsidiary of Houston Casualty, and Perico Life Insurance Company, which is a wholly owned subsidiary of HCC Life Insurance Company.

Approximately 18% of HCC’s 2007 insurance revenues are derived from foreign operations. These are primarily through the Houston Casualty’s London branch office, as well as Spain-based subsidiary, HCC Europe, and London-based subsidiary, HCC International Insurance Company plc (HCC International). The company also has a small Bermuda subsidiary, HCC Reinsurance Company Limited.

Key Events

HCC has been active in opportunistically growing earnings and diversifying operations through strategic acquisitions. Many of these acquisitions are of underwriting agencies that have an established book of business that can eventually be written through one of HCC’s insurance subsidiaries. However, the company also has acquired insurance companies in the past as well.

HCC primarily operates in the U.S., U.K., Spain, Bermuda, Belgium and Ireland.

HCC acquires companies to diversify into new specialty lines of business or to grow existing lines of business.

HCC Insurance Holdings, Inc. Recent Acquisitions

Year	Company Acquired	Segment
2009	Surety Company of the Pacific ^a	License and permit bond underwriter.
2008	Cox Insurance Group	Medical stop-loss managing general underwriter.
2008	MultiNational Underwriters, LLC	Underwriting agency focused on short-term medical insurance
2006	Health Products Division (Allianz Life Insurance Co. of North America)	Medical stop-loss and medical excess insurance company
2006	G.B. Kenrick & Associates, Inc.	Underwriting agency specializing in municipal insurance in the Midwest.
2005	HCCL Holdings Limited (UK) (formerly Illium Insurance Group, Ltd.)	Managing agent for Lloyd's Syndicates 4040 and 4041.
2005	Perico Ltd.	Medical stop-loss insurance underwriting agency.
2005	Perico Life Insurance Company (formerly MIC Life Insurance Corp.)	Group life, accident and health insurance company
2005	HCC International (formerly De Montfort Insurance Co.)	U.K. insurance company focused on diversified financial products
2005	United States Surety Company	Surety insurance company

^aNote: This transaction is subject to approval of the California Department of Insurance and is expected to close during the first quarter of 2009.
Source: Company reports.

Two of the company's largest acquisitions were the 1999 acquisition of Centris Group, Inc., which greatly expanded HCC's market position in the medical stop-loss business, and the 2006 acquisition of the assets of the health products division of Allianz Life Insurance Company. This acquisition has allowed HCC to continue to grow its medical stop-loss business for self-insured corporations as well as provide some diversification into excess insurance for health maintenance organizations (HMOs) and excess medical reinsurance to small and regional carriers.

In recent years acquisition activity has remained frequent, but a majority of the purchases are more modest in size and focus mainly on surety and professional liability insurance producers and underwriting agencies as well as medical stop-loss producers and underwriting agencies.

Fitch believes HCC's strategy of making smaller acquisitions has historically been successful for the company. Unlike peers that have made large acquisitions and subsequently had to re-underwrite the book of business and strengthen prior-period reserves, HCC has faced minimal execution and integration risks.

Products

The diversified financial products line of business focuses on professional liability coverage, including directors' and officers' liability, employment practices liability and errors and omissions coverage. Also included in this segment is surety and credit coverage. This has been the fastest growing segment within HCC in recent years. The company entered this business in 2001 and has grown organically and through acquisitions in the U.S. and Europe.

The group life, accident and health line of business primarily writes medical stop-loss coverage for employer-sponsored self-insured health plans, which allows organizations that self-insure their group medical insurance exposure to limit their retention of aggregate and specific losses. This segment writes a small amount of group life insurance as a complementary product to the stop-loss coverage, and in 2006 the company began writing medical excess insurance. With the purchase of MultiNational Underwriters, LLC in 2008, HCC began writing short-term medical insurance that covers individuals when there is a lapse in coverage or when travelling internationally.

Aviation is a highly specialized line of business. HCC, which has been in the aviation business since 1981, is one of the largest writers of private aircraft insurance in the U.S.

Since 2003, gross written premium has increased for all segments, except for its London Market and Aviation segments.

and offers general aviation coverage throughout the world. Aviation coverage written includes protection for hulls, engines, systems, liability and cargo. It focuses on smaller aviation risks, including private aircraft, antique and vintage military aircraft, commuter airlines, corporate aircraft and cargo operations. The company does not insure major airlines, airline manufacturers or satellites.

London market business consists of marine, energy, property, and accident and health business. This business is written through Houston Casualty's London branch office and HCC International. This segment tends to write larger gross limits that are significantly reinsured both proportionally and on an excess of loss basis.

Other specialty lines include marine business in the U.S., which includes coverage of tugs and barges, as well as a quota share arrangement that expired on March 31, 2008, on surplus lines business written by Argo Group, employer liability and commercial motor business written by an affiliated Lloyds syndicate and the Kenrick business.

Target Markets

The target market for HCC varies considerably by line of business. The group life, accident and health line of business targets small and midsize corporations that opt to self-insure their employee benefits.

The diversified financial products segment focuses on providing directors' and officers' coverage to Fortune 1,000, multinational private and nonprofit companies mainly in the U.S. and Europe, as well as errors and omission and employment practices liability insurance (EPLI) coverage for small employers and professionals. Surety activity is currently concentrated in the U.S., U.K. and Spain.

London market operations focus on large property risks for Fortune 1,000 and multinational customers. Energy business is geared towards large accounts covering refineries, offshore platforms and drilling rigs. Marine business focuses on ocean fleets worldwide.

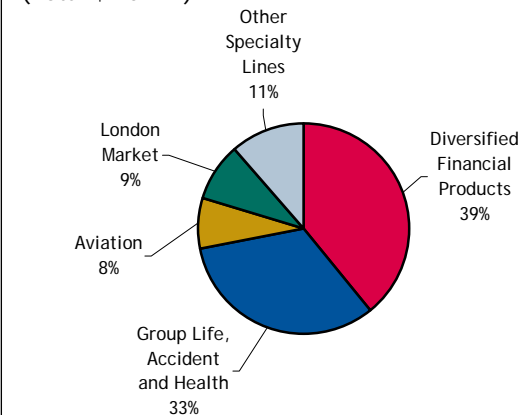
Distribution Channels

HCC's product distribution sources vary by segment. The majority of the company's business is written through outside brokers and agents that specialize in the various product and geographic segments in which the company specializes. Certain domestic general aviation business is written directly to insureds.

The company's ownership of several underwriting agencies that write through other HCC subsidiaries as well as other insurers is somewhat unique, providing the company with a ready source of premium. Underwriting agency and intermediary subsidiaries of HCC focus principally on professional liability business, marine and other specialty business.

HCC's ownership of several underwriting agencies provides the company with a ready source of premium.

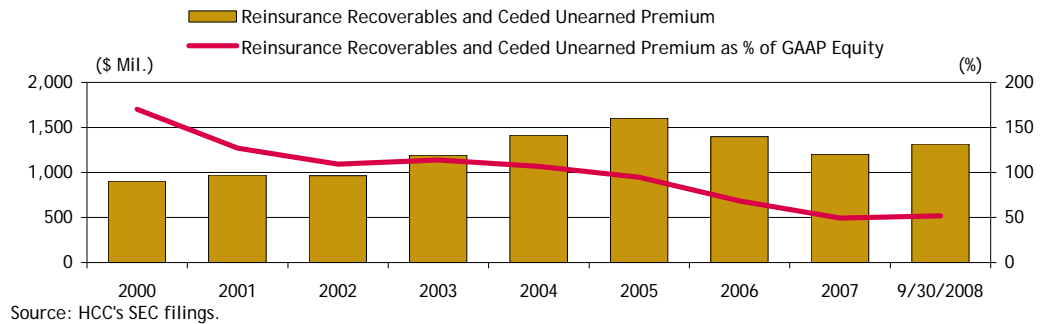
2007 Gross Written Premium
(Total \$2.5 Bil.)



Source: SEC form 10-K.

HCC has been reducing its reinsurance recoverables through less use of reinsurance as well as commutations.

Reinsurance Recoverables



Financial Analysis

Profitability

See Key Rating Issues section.

Investments and Liquidity

See Key Rating Issues section.

HCC had letters of credit and cash deposits held as collateral, plus other credits for potential offset totaling \$561 million at Sept. 30, 2008.

Reinsurance Protection and Credit Quality

Historically HCC had utilized significant amounts of ceded reinsurance coverage to manage risk exposures and operating leverage. The company required considerable reinsurance coverage in its earlier years as it wrote relatively large gross lines in some segments (aviation, property, marine) relative to its capital base. This reinsurance strategy has proven successful overall for the company over the years; however, greater reliance on reinsurance tends to trade underwriting risk for credit risk on reinsurance recoverables.

In response to favorable market conditions and a growth in its underwriting capacity in recent years, HCC is retaining a greater portion of its gross premiums. At year-end 2007, the company ceded approximately 19% of its gross premiums to reinsurers, down significantly from 53% at year-end 2002. HCC's strategy is to increase its retention in

15 Largest Reinsurance Recoverables at Year-End 2007

(\$000)

Reinsurer Group Name	Recoverable	Collateral	Net Recoverable
Lloyds Of London	202,711	6,131	196,580
Hannover Group	60,180	4,060	56,120
Swiss Re Group	67,915	13,172	54,743
IAT Insurance Group	46,927	0	46,927
Arch Capital Group	49,173	6,401	42,772
ACE Ltd Group	38,964	1,080	37,884
AIG	28,368	0	28,368
Everest Re Group	35,346	8,562	26,784
Platinum Underwriters Holdings, Ltd	22,938	0	22,938
Berkshire Hathaway Group	16,506	56	16,450
Argonaut Insurance Group	15,960	0	15,960
Fairfax Financial Holdings	14,642	1	14,641
Munich Re Group	14,099	2,619	11,480
Intl General Insurance Co Ltd	10,284	0	10,284
White Mountains Ins Group	9,528	255	9,273
Total Largest 15 Recoverables	633,541	42,337	591,204

Source: ScheduleF.com.

those lines of business that are not generally exposed to catastrophes and where results are less volatile. The company continues to purchase significant reinsurance to protect against catastrophe losses.

While the quality of HCC's reinsurers is generally adequate, there is a significant concentration of recoverables with Lloyd's of London (Fitch insurer financial strength rating of 'A+') that is distributed with a number of individual syndicates. HCC had a reserve of \$8.4 million for potential collectability issues related to reinsurance recoverables at Sept. 30, 2008.

Reserve Adequacy and Development

At Sept. 30, 2008, HCC's GAAP consolidated gross loss reserves were \$3.5 billion, and net loss reserves were \$2.5 billion. The company's reserves were historically concentrated in shorter-tail business lines, which lessened uncertainty related to reserve adequacy. However, the duration of HCC's reserve liabilities has increased with the recent growth of longer-tail professional liability and surety business. The company has very little exposure to asbestos and environmental risks.

HCC's favorable prior year reserve development of \$58.4 million in the first nine months of 2008 resulted from a re-estimation of its net exposure for certain case basis reserves and reserve reductions in the diversified financial products line in the 2005 and prior underwriting years and in the London market business for 2005 and prior. As a result of uncertainty in financial markets, HCC increased 2008 accident year reserves principally for directors and officers liability business by \$35 million, primarily for policies written in 2007.

HCC reported favorable reserve development of \$26.4 million in 2007 primarily related to the diversified financial products line for the 2003 and 2004 underwriting years. In 2006, the company had favorable reserve development of \$6.5 million primarily driven by reductions in prior-year hurricane reserves and redundancies in the aviation and energy lines of business partially offset by a commutation charge of \$20.2 million. This followed an adverse development of \$25.4 million in 2005 that resulted from a commutation charge, \$30.5 million in 2004 due to assumed accident and health business in its discontinued line and \$28.8 million in 2003 related to a commutation.

HCC shows the low and high end of reserve ranges estimated by the company's actuaries for each major segment, relative to recorded reserves in its form 10-K filings. At year-end 2007, the recorded reserves were above the midpoint of high and low estimates and the actuarially determined point estimate.

The concentration of reserves in shorter-tail lines makes an analysis of statutory reserve data in Schedule P less meaningful. However, Fitch's loss reserve model indicates some redundancy in HCC's property/casualty subsidiaries statutory reserves for its longer-tail lines at year-end 2007.

Unfavorable reserve development in 2003–2005 was primarily due to reinsurance commutations. Under GAAP any excess of undiscounted reserves assumed over assets received are recorded at a loss at the time the commutation is completed.

Reserve Adequacy and Development

(\$ Mil.)

	3Q08	3Q07	2007	2006	2005	2004	2003
Beginning of the Year Reserves	3,227	3,097	3,097	2,814	2,089	1,535	1,155
Beginning of the Year Total Equity	2,440	2,043	2,043	1,694	1,324	1,047	883
Prior Accident Year (PAY) Reserve Development	(58)	(19)	(26)	(7)	25	30	24
PAY/Beginning of Year Reserves (%)	(1.8)	(0.6)	(0.9)	(0.2)	1.2	2.0	2.1
PAY/Beginning of the Year Total Equity (%)	(2.4)	(0.9)	(1.3)	(0.4)	1.9	2.9	2.7

Source: SNL Financial, company SEC filings.

Capitalization

See Key Rating Issues section.

Financial Leverage and Balance Sheet Quality

HCC's debt consists of 1.3% convertible notes, which can be put to the company on April 1, 2007, 2014, and 2019 and by the company anytime after April 1, 2009, as well as \$250 million outstanding on its line of credit, which includes \$200 million the company used to redeem its 2% convertible notes in 2007. HCC indicated it would use the revolving credit facility to fund any payment of the 1.3% convertible notes.

In June 2008, HCC's board of directors approved the repurchase of up to \$100 million of common stock. Through Oct. 31, 2008, the company has repurchased 1.7 million shares at a cost of \$34.2 million.

Going forward, Fitch expects HCC's debt-to-total-capital ratio to rise as the company continues to make acquisitions, but remain below 25%.

Debt-Servicing Capabilities

Fitch views HCC's debt-servicing capabilities and liquidity position as solid. Interest coverage has steadily improved over the past five years and was very strong at 56.6x in 2007. Interest coverage levels benefit from the considerably lower interest rate on HCC's convertible debt obligation, relative to the equivalent interest rate that would be required on a nonconvertible obligation.

The holding company has adequate resources to meet its current interest and principal obligations on its outstanding debt. The parent company had approximately \$37 million in cash and short-term investments at year-end 2007. Historically, HCC relied on cash flow from its agencies to meet parent-company obligations. However, as more profit is expected to be earned in its insurance operations, HCC indicated it may have to partially depend on insurance subsidiary dividends. The maximum dividend that HCC could receive in dividends from its directly owned U.S. insurance subsidiaries in 2008 is approximately \$160.8 million, which equals approximately 10.5x HCC's estimated interest expense in 2008.

Other liquidity sources include HCC's \$575 million revolving loan facility with several banks, which expires on Dec. 19, 2011. Additionally, at HCC's option, and subject to the lenders' ability to obtain the necessary commitments, the amount available under the facility may be increased to an aggregate of \$700 million. At Sept. 30, 2008, HCC had outstanding borrowings of \$250 million and the company borrowed an additional \$75 million in October 2008 to provide funding for stock repurchases and a pending acquisition.

At Sept. 30, 2008, HCC had \$835 million of goodwill that was largely related to its acquisitions. Excluding goodwill, HCC's debt-to-total capital ratio increased to 18%.

Financial Leverage and Balance Sheet Quality

(\$ Mil.)

	9/30/08	9/30/07	2007	2006	2005	2004	2003
Total Capital	2,922	2,626	2,765	2,352	2,000	1,637	1,357
% Total Debt	12.8	11.6	11.7	13.1	15.5	19.0	22.9
% Preferred Equity	—	—	—	—	—	—	—
% Minority Interest	—	—	—	—	—	—	—
% Common Equity	87.2	88.4	88.3	86.9	84.5	81.0	77.1
% Equity Credit Adjusted Leverage	10.5	7.8	9.5	6.8	8.0	9.9	NA
% Total Debt/Tangible Capital	18.0	16.4	16.3	19.4	21.4	26.6	32.7

NA – Not available.
Source: SNL Financial, company SEC filings.

HCC's interest coverage ratios will likely decline in 2009 with the redemption of its outstanding convertible debt, which has a considerably lower interest rate than non-convertible obligations.

Debt-Servicing Capabilities

(\$ Mil.)

	YTD		2007	2006	2005	2004	2003
	3Q08	3Q07					
Interest Expense	12	7	10	11	8	8	7
Operating EBIT/Interest Exp. (x)	31.8	63.1	56.6	45.8	36.3	29.0	23.0
Cash Flow from Operations	401	615	726	653	624	669	528

Source: SNL Financial, company SEC filings.

Fitch believes HCC has good financial flexibility and access to capital markets. The company filed a shelf registration in May 2006 for an aggregate of \$1 billion of securities, of which HCC has the full amount available to be issued.

Fitch expects GAAP earnings-based interest coverage ratio to remain very high in 2008 at over 10x.

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