

**Composite Multi-Line
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 | 9/30/09 | 269.1 |
| Equity | 9/30/09 | 2,987.4 |
| Debt and Hybrids | 9/30/09 | 444.7 |
| Operating ROAE (%) | 9/30/09 | 18.6 |

Analysts

Dafina M. Dunmore, CFA
+1 312 368-3136
dafina.dunmore@fitchratings.com

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

Related Research

Applicable Criteria

- [Insurance Rating Methodology, Dec. 29, 2009](#)
- [Non-Life Insurance Rating Criteria \(Global\), March 2, 2007](#)

Other Research

- [Review & Outlook 2009–2010 — U.S. Property/Casualty Insurance, Dec. 8, 2009](#)
- [Fitch Rates HCC's \\$300MM Sr. Unsecured Notes 'A'; Outlook Stable, Nov. 11, 2009](#)
- [Fitch Ratings Affirms HCC Insurance Holdings; Outlook Stable, Nov. 5, 2009](#)
- [Property/Casualty Industry Loss Reserve Adequacy — At a Crossroads, Nov. 2, 2009](#)
- [Insurance Industry Rating Outlooks: Global Update, Sept. 2, 2009](#)
- [Property/Casualty Insurer Investment Risk and Performance, Aug. 24, 2009](#)
- [Life Industry Outlook: The Rating Agency Perspective \(Presentation\), May 18, 2009](#)

Rating Rationale

- HCC Insurance Holdings, Inc.'s (HCC) rating reflects its leading market position in a number of narrowly defined, lower correlated specialty insurance segments, strong underwriting results, and solid capitalization at the operating company level. Operating leverage as measured by net premiums written to policyholders' surplus for the U.S.-domiciled property/casualty companies remains low at 0.6x.
- HCC maintains underwriting discipline throughout pricing cycles as well as an ability to select and integrate acquisitions, as evidenced by an average combined ratio of approximately 89% from 1991 to 2008.
- Despite the tumultuous capital markets in 2008, HCC increased its GAAP equity by 8% during the year due to strong underwriting results and minimal investment losses. Aided by the improvement in financial markets during third-quarter 2009, HCC's equity expanded an additional 13% to approximately \$3 billion as of Sept. 30, 2009.
- Fitch Ratings considers HCC's investment portfolio to be conservative with the majority of its assets invested in high-quality fixed-income securities. The company has no direct exposure to equities and its alternative investment exposure (primarily fund-of-fund hedge fund investments) has been eliminated.
- In November 2009, HCC issued \$300 million of long-term debt, which was used to pay down its bank revolver. The company also announced plans to redeem the remaining outstanding balance of its convertible notes. Fitch views these transactions as an improvement to HCC's capital structure while providing enhanced flexibility. The company's debt-to-total capital ratio is expected to decline to approximately 9.1% from 13% at Sept. 30, 2009.
- Offsetting factors to the rating include HCC's exposure to the credit market crisis from a liability perspective through its directors and officers (D&O), errors and omissions (E&O), fidelity, surety, and credit books of business. Additionally, Fitch will continue to monitor trends in the company's residual value business written through HCC Indemnity Guaranty, which is currently modest in size.

Key Rating Drivers

- Fitch expects HCC to continue to report favorable operating profits in 2010 and 2011, albeit down from recent record levels due to soft market conditions and economic pressure.
- Fitch expects HCC to continue to seek opportunities for growth through acquisitions, funding for which may lead to periodic increases in financial leverage. However, debt-to-total-capital ratio is not expected to exceed 25% and GAAP earnings-based interest coverage should remain above 10x.
- While HCC has exposure to D&O and E&O claims from the subprime mortgage market meltdown, Fitch believes it is manageable and does not anticipate a significant uptick in the company's loss ratio.

HCC generates consistent underwriting profits and continues to outperform the industry with an 84.6% combined ratio through the first nine months of 2009.

Key Rating Issues

Unique Business Model with Consistently Strong Operating Results

HCC's underwriting operations focus on several narrowly defined, lower correlated specialty property/casualty insurance lines, which produce regular underwriting profits and below-average volatility in both underwriting performance and loss reserves over a long period of time. Fitch believes the company's underwriting expertise in its chosen specialty lines and operating flexibility are evidenced by its above-average operating results over the long term.

HCC has experienced strong revenue growth in the last several years as a result of acquisitions and organic growth coupled with less reliance on reinsurance. The company's acquisition focus is on underwriting teams in addition to underwriting agencies and insurers to augment its product offering. As a result, net earned premiums increased at a five-year average annual growth rate of 22%. While HCC has integrated prior acquisitions well, Fitch notes the inherent execution risk of an acquisitive growth strategy.

Net earned premiums grew by an average annual rate of 22% through the five-year period ending 2008, in part aided by acquisitions.

Property/Casualty Underwriting Ratios

(%)

| | Nine Months Ended | | 2008 | 2007 | 2006 | 2005 | 2004 |
|-------------------|-------------------|---------|------|------|------|------|------|
| | 9/30/09 | 9/30/08 | | | | | |
| Return on Assets | 5.3 | 6.5 | 9.4 | 9.1 | 8.4 | 3.6 | 4.3 |
| Return on Surplus | 7.9 | 9.5 | 17.1 | 19.6 | 21.1 | 6.9 | 8.0 |
| Loss Ratio | 49.2 | 49.0 | 48.8 | 48.3 | 52.9 | 64.3 | 63.9 |
| Expense Ratio | 27.1 | 25.4 | 30.7 | 29.8 | 27.9 | 29.8 | 28.3 |
| Combined Ratio | 76.4 | 74.4 | 79.5 | 78.1 | 80.9 | 94.1 | 92.2 |

Note: Statutory accounting principles.
Source: HCC Insurance Holdings Group.

HCC continues to exhibit consistently sound underwriting results with a five-year statutory combined ratio of 85% compared with 98.5% for the industry. Fitch believes that while HCC's combined ratio will increase due to the continued soft pricing environment, the company's underwriting expertise and focus on niche products should enable it to continue to produce better results than its peers.

Operating Results

(\$ Mil.)

| | Nine Months Ended | | 2008 | 2007 | 2006 | 2005 | 2004 |
|---------------------------------------|-------------------|---------|-------|-------|-------|-------|-------|
| | 9/30/09 | 9/30/08 | | | | | |
| Premiums Earned | 1,524 | 1,505 | 2,008 | 1,985 | 1,709 | 1,370 | 1,011 |
| Total Revenue (Before Realized Gains) | 1,784 | 1,746 | 2,307 | 2,375 | 2,076 | 1,641 | 1,279 |
| % Change | 2 | (2) | (3) | 14 | 26 | 28 | 36 |
| Pretax Realized Gains | 2 | (17) | (28) | 13 | (1) | 1 | 6 |
| Interest Expense | 12 | 15 | 20 | 16 | 18 | 14 | 12 |
| Pretax Operating Income | 391 | 352 | 460 | 567 | 504 | 265 | 231 |
| Preferred Dividends | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net Income Available to Common | 269 | 231 | 302 | 392 | 338 | 187 | 160 |
| % Pretax Operating Return on Assets | 6.0 | 5.7 | 5.6 | 7.2 | 6.9 | 4.1 | 4.3 |
| % Return on Common Equity | 12.8 | 12.3 | 11.9 | 17.4 | 18.0 | 12.3 | 13.4 |

Note: GAAP accounting.
Source: 10-Q filings.

Additionally, the fee-based businesses of HCC's insurance agency operations provide 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. However, fee-based revenues will likely decline in the future given the recent sale of its reinsurance broker, Rattner Mackenzie Limited (RML), to Guy Carpenter & Company, LLC, reduced reinsurance utilization, and greater amounts of affiliated agency business written through HCC's insurance company subsidiaries.

Capitalization

(\$ Mil.)

| | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|-------|-------|-------|------|------|
| Beginning of Period Surplus | 1,472 | 1,118 | 966 | 761 | 551 |
| Net Income | 261 | 254 | 220 | 59 | 51 |
| Unrealized Gains | (24) | 74 | (103) | 34 | 29 |
| Paid in Capital/Surplus | 1 | 10 | 19 | 175 | 95 |
| Dividends to Stockholders | (112) | (23) | (28) | (55) | (31) |
| Other Changes | (25) | 38 | 43 | (6) | 51 |
| Total Changes | 102 | 354 | 152 | 206 | 196 |
| End of Period Surplus | 1,574 | 1,472 | 1,118 | 966 | 747 |
| Dividend Payout (%) | 42.8 | 8.9 | 12.7 | 93.6 | 60.3 |
| Net Premium Written/Policyholder Surplus | 0.64 | 0.66 | 0.89 | 0.96 | 1.06 |
| Net Leverage ^a | 2.31 | 2.34 | 3.03 | 3.09 | 3.03 |
| NAIC Risk-Based Capital Ratio | 241 | 245 | 226 | 210 | 257 |
| Non-Investment Grade Bonds/Policyholder Surplus (%) | 0.1 | 0.2 | 0.3 | 0.1 | 0.1 |

^aNet Leverage is total liabilities plus net premium written/policyholders' surplus. Note: Statutory accounting principles.
Source: HCC Insurance Holdings Group.

HCC remains well-capitalized with low operating leverage of 0.6x and a 240% RBC as of year-end 2008.

The company generated GAAP earnings of approximately \$302 million in 2008, a reduction of 23% from the prior year. The decline was due primarily to hurricane losses and investment losses, including losses from alternative investments and trading securities. HCC discontinued active trading of securities in 2006 and sold its remaining two positions in 2008, along with eliminating all exposure to alternative investments. Through Sept. 30, 2009, net earnings grew 17% to \$269 million due to strong operating performance with no impact from catastrophes.

Solid Capitalization with Improved Capital Structure

Based on results from Fitch's economic capital model, Prism, as well as traditional measures of capital, Fitch believes HCC's insurance subsidiaries are adequately capitalized. Operating leverage — net written premiums to policyholders' surplus — for the consolidated U.S. property/casualty operation remains low at 0.6x as of year-end 2008. Additionally, Fitch views the NAIC risk-based capital (RBC) ratio for Houston Casualty, the lead insurer in the group, of 240% of the company action level at year-end 2008 and 280% estimated at Sept. 30, 2009 as adequate.

In contrast to its peers, HCC expanded its book equity during 2008–2009 partially due to the conservative nature of its investment portfolio.

In a year when many property/casualty insurers suffered meaningful declines in GAAP equity, HCC expanded its book value by 8% in 2008 and another 13% through Sept. 30, 2009 to approximately \$3 billion. Consolidated policyholders' surplus (PHS) has more than doubled since 2004, totaling approximately \$1.9 billion at Sept. 30, 2009. This growth has been primarily driven by strong earnings and minimal investment losses.

On Nov. 10, 2009, HCC issued \$300 million of 10-year senior notes, the proceeds of which were used to pay down the outstanding balance on its revolving bank line of

credit. Also, on Nov. 20, 2009, HCC announced its intent to redeem the remaining outstanding balance of its 1.3% convertible notes totaling \$124.7 million, which is expected to take place by year end. Following these transactions, HCC's debt-to-total capital ratio will decline to approximately 9.7% (excluding any contribution for fourth-quarter earnings) from 13% at the end of third-quarter 2009. However, Fitch expects the company's debt-to-total-capital ratio to rise as the company continues to make acquisitions, but should remain below 25%.

Fitch expects operating earnings-based interest coverage to remain strong, albeit at a lower level given modestly higher expected interest expense on long-term debt. Fitch views the reduced level of debt and additional flexibility provided by the long-term debt issue as an improvement to HCC's capital structure and liquidity.

The average credit rating on HCC's fixed-income securities is 'AA+' and it has no exposure to equities or alternative investments.

Conservative Investment Portfolio

Somewhat contributing to the continuous growth in capital is HCC's conservative investment portfolio, which has performed well throughout the global financial crisis. The majority of the company's assets are invested in high-quality fixed-income securities with average credit quality of 'AA+' as of Sept. 30, 2009.

HCC has minimal exposure to the real estate market with only 1% of total invested assets in non-government agency MBS, 90% of which consist of prime loans. CMBS comprise almost 3% of the company's total invested assets with an average rating of 'AAA'.

HCC has no direct exposure to equities and, during the third quarter of 2008, the company notified its fund managers of its intention to liquidate all exposure to alternative investments. The company currently has no remaining exposure.

HCC recognized a modest \$28 million of realized investment losses during 2008, including other-than-temporary impairments (OTTI) of \$11.1 million. Through Sept. 30, 2009, the company's realized investment gains were offset by OTTI. Favorably, HCC has a net unrealized gain position of \$209.3 million on its fixed-income securities as of Sept. 30, 2009, up from \$15 million at Dec. 31, 2008.

Asset Portfolio

(\$ Mil.)

| | Nine Months Ended | | 2008 | 2007 | 2006 | 2005 | 2004 |
|--------------------------|-------------------|---------|-------|-------|-------|-------|-------|
| | 9/30/09 | 9/30/08 | | | | | |
| Cash and Invested Assets | 5,693 | 5,041 | 5,007 | 4,905 | 4,153 | 3,502 | 2,727 |
| % Fixed Income | 86 | 78 | 85 | 75 | 72 | 65 | 62 |
| % Equities | — | — | 0 | 1 | 2 | — | — |
| % Cash and Short-Term | 11 | 15 | 10 | 17 | 18 | 26 | 29 |
| % Other | 3 | 7 | 4 | 7 | 7 | 9 | 8 |

Note: GAAP accounting.
Source: 10-Q filings.

Potential Impact of Credit and Economic Crisis on Businesses

Fitch notes that while HCC's asset portfolio has been largely unscathed by the recent credit market crisis, the company remains exposed from a liability perspective through its directors and officers (D&O), errors and omissions (E&O), fidelity, surety and credit books of business.

In light of the recent crisis, HCC examined its exposure to subprime-related claims. As of Sept. 30, 2009, the company had 17 Side A-only D&O claims (which provide only direct coverage to directors and officers) and 73 non-Side A-only D&O claims (which cover the

HCC is exposed to the credit market crisis through its D&O and E&O businesses, although Fitch believes the company is currently adequately reserved for this business.

corporation’s legal obligation to indemnify the directors and officers). Of the claims reported, four are on primary policies with gross policy limits totaling \$20 million with remaining claims on excess policies. HCC increased its 2008 accident-year loss picks for claims primarily related to D&O and E&O, which was somewhat offset by favorable reserve development in earlier accident years for these products. Fitch expects ultimate losses related to these claims to be contained within current reserve levels.

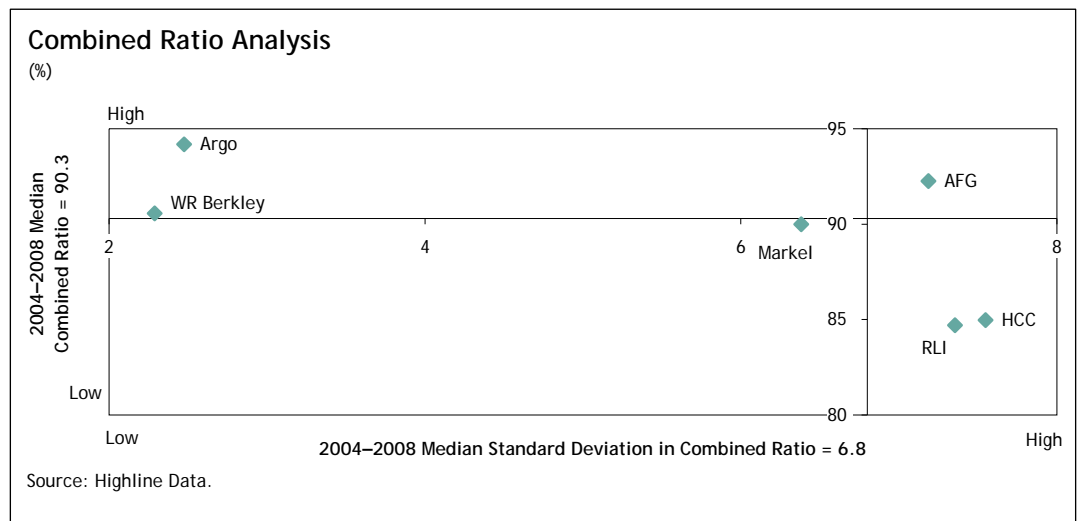
Additionally, HCC has a small residual value business that insures minimum asset values, primarily commercial real estate and international aircrafts. While Fitch believes lease provisions and guaranty amounts relative to estimated values mitigate the risk, the difficulty in estimating future values increases uncertainty. Favorably, there are no collateral posting requirements or downgrade triggers related to this business and Fitch believes the company’s exposure is manageable at its current level.

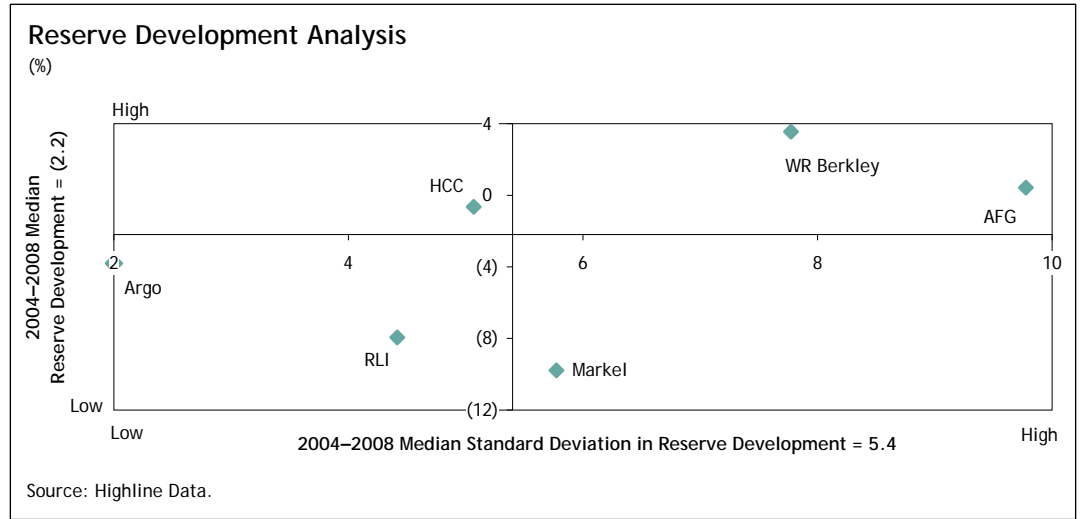
Peer Analysis

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

Underwriting Profitability

HCC’s underwriting profitability has been better than its peer average for the five-year period ending 2008. Moreover, HCC outperformed its specialty lines peers across pricing cycles as evidenced by an average combined ratio of 89% from 1991–2008, or roughly 10 points lower than the peer average. Over that period HCC underperformed its peers in only one year: 1999.





Reserve Adequacy

HCC's reserves developed modestly favorable over the five-year period ending 2008, which indicates that its underwriting results have been less affected by reserve development over that time period. Additionally, volatility of reserve development has been lower than peers.

HCC has continued to outperform many of its specialty lines peers during the first nine months of 2009, with persistently strong underwriting results. Although most property/casualty insurers increased shareholders' equity during 2009 due to the reversal of unrealized investment losses, HCC was the only company within Fitch's rating universe to increase shareholders' equity during 2008 as well.

Peer Results

(%, YTD Sept. 30, 2009)

| | Loss Ratio | Expense Ratio | Combined Ratio | Reserve Development/ | Operating ROE | Net Income ROE | YTD Change in GAAP Equity |
|--------------------------|------------|---------------|----------------|----------------------|---------------|----------------|---------------------------|
| HCC | 59.8 | 24.8 | 84.6 | -2.4 | 18.6 | 12.8 | 13.2 |
| Argo Group | 60.7 | 36.2 | 96.9 | 0.9 | 10.2 | 7.0 | 16.3 |
| RLI | 42.5 | 40.4 | 82.9 | -12.2 | 18.9 | 11.0 | 16.8 |
| American Financial Group | 46.2 | 36.0 | 82.2 | -10.1 | 24.3 | 14.9 | 46.1 |
| Markel | 57.1 | 39.8 | 96.9 | -10.0 | 13.1 | 5.9 | 23.5 |
| W.R. Berkley | 62.4 | 32.3 | 94.7 | -4.7 | 7.7 | 7.0 | 18.2 |

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, 2008)

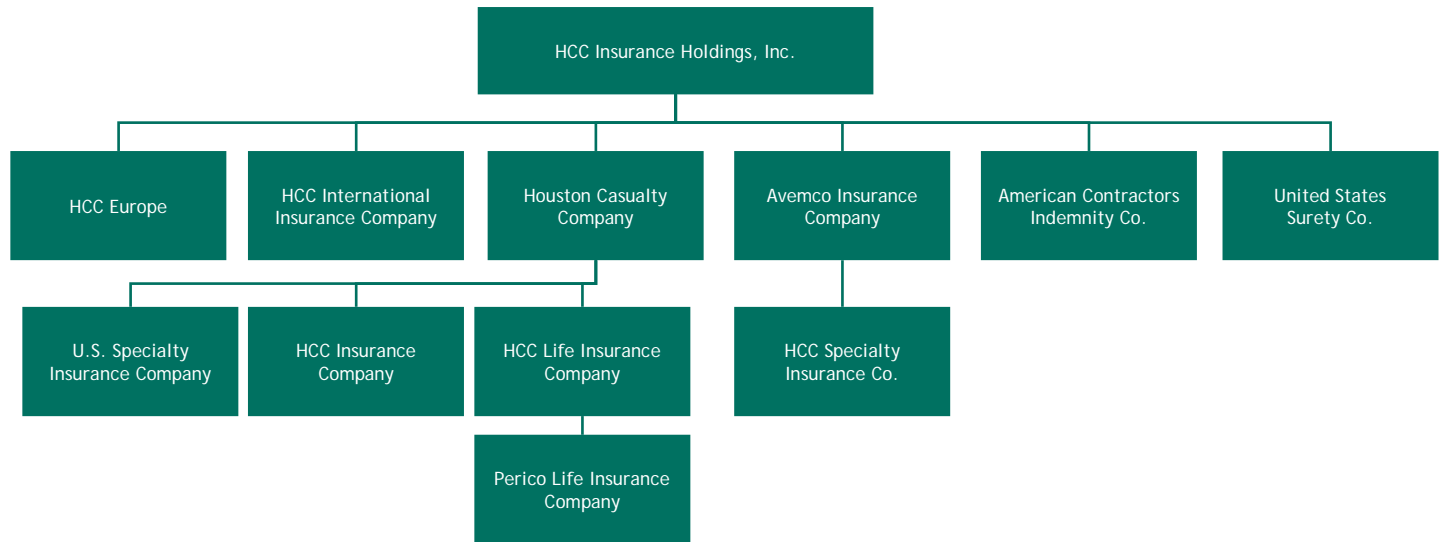
| | IFS | RBC (%) | NPW/PHS (x) | Net Leverage (x) | Gross Leverage (x) |
|--------------------------|-----|---------|-------------|------------------|--------------------|
| HCC | AA | 241 | 0.6 | 2.3 | 3.1 |
| American Financial Group | A+ | 168 | 1.4 | 4.7 | 6.8 |
| RLI | A | 436 | 0.8 | 2.5 | 3.3 |
| Markel | A | 120 | 1.4 | 4.8 | 5.6 |
| W.R. Berkley | A | 123 | 1.1 | 4.3 | 6.0 |
| Argonaut | NR | 206 | 0.8 | 3.9 | 5.9 |

IFS – Insurer financial strength. RBC – Risk-based capital ratio for primary property/casualty subsidiary. NPW – Net premium written. PHS – Policyholders' surplus. NR – Not rated.

Source: Statutory filings with NAIC.

Based on traditional measures of capital, HCC is among the best capitalized companies of its peer group with the lowest operating leverage ratios and the highest RBC ratio behind RLI Corp. This level of capitalization is reflected in HCC's rating, which is also higher than its peers'.

Simplified Organizational Structure



Source: HCC.

Company Profile

Ownership Structure

HCC is a specialty insurance group formed in 1974 and based in Houston, TX. The company is traded on the New York Stock Exchange (NYSE) and had a market capitalization of \$2.9 billion as of Nov. 30, 2009.

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.

HCC operates primarily in the U.S., the U.K., Spain, and Ireland. The international business is primarily written through the Houston Casualty's London branch office, as well as Spain-based subsidiary HCC Europe, London-based subsidiary HCC International Insurance Company plc (HCC International), and a Lloyd's syndicate.

Key Events

HCC targets small- to modest-sized acquisitions as a strategy for continued growth and diversification.

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 has also acquired insurance companies in the past as well.

In recent years, acquisition activity has remained frequent. A majority of purchases have been 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. 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.

Recent Acquisitions — HCC Insurance Holdings, Inc

| Year | Company Acquired | Segment |
|------|--|---|
| 2005 | United States Surety Company | Surety insurance company. |
| 2005 | HCC International (formerly De Montfort Insurance Co.) | U.K. insurance company focused on diversified financial products. |
| 2005 | Perico Life Insurance Company (formerly MIC Life Insurance Corp.) | Group life, accident and health insurance company. |
| 2005 | Perico Ltd. | Medical stop-loss insurance underwriting agency. |
| 2005 | HCCL Holdings Limited (UK) (formerly Illium Insurance Group, Ltd.) | Managing agent for Lloyd's Syndicates 4040 and 4141. |
| 2006 | G.B. Kenrick & Associates, Inc. | Underwriting agency specializing in municipal insurance in the Midwest. |
| 2006 | Health Products Division (Allianz Life Insurance Co. of North America) | Medical stop-loss and medical excess insurance company. |
| 2008 | MultiNational Underwriters, LLC | Underwriting agency focused on short-term medical insurance. |
| 2008 | Criminal Justice division of U.S. Risk Insurance Brokers | Underwriting agency serving the private detention and security industry. |
| 2008 | Cox Insurance Group | Medical stop-loss MGU covering the Midwest. |
| 2008 | Arrowhead Public Risk | MGA specializing in risk management for the public entity sector. |
| 2008 | VMGU Insurance Agency | Underwriter of lumber, building materials, forest products, and woodworking industries. |
| 2009 | Surety Company of the Pacific | License and permit bond writer for California contractors. |

MGU – Managing general underwriter. MGA – Managing general agent.
Source: Company reports.

On Nov. 30, 2009, HCC announced its intent to merge its two Lloyd's syndicates, which will increase its presence in Lloyd's and aid international growth.

In late 2009, HCC sold its reinsurance broker affiliate, RML, to Guy Carpenter & Company, LLC in an effort to focus on its core businesses.

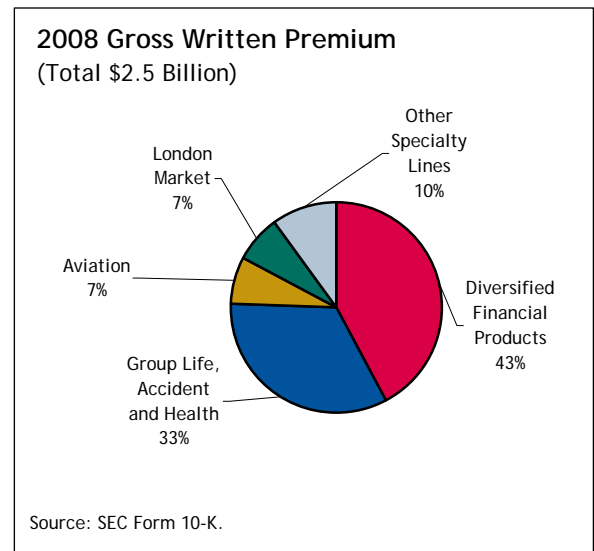
Products

HCC's diversified financial products line of business focuses on professional liability coverage, including D&O liability, employment practices liability (EPLI), and E&O

coverage. Also included in this line of business is surety and credit coverage. This is HCC's largest line of business and it has grown tremendously since entering this market in 2001 both 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. With recent acquisitions, this has been the fastest growing line of business within HCC in recent years. The company also 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 traveling 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. 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 line of business tends to write larger gross limits that are significantly reinsured both proportionally and on an excess of loss basis.

HCC also underwrites various other specialty lines of business, such as event cancellation, contingency, public entity, and U.K. liability. The company had an assumed quota-share contract for surplus lines business that expired in March 2008.

Target Markets

The target market for HCC varies considerably by line of business. The diversified financial products line of business focuses on providing D&O coverage to Fortune 1,000, multinational private and nonprofit companies mainly in the U.S. and Europe, as well as E&O and EPLI coverage for small employers and professionals. Surety activity is currently concentrated in the U.S., U.K., and Spain.

The group life, accident, and health line of business targets small and midsize corporations that opt to self-insure their employee benefits. London market operations focus on large property risks for Fortune 1,000 and multinational customers. Energy business is aimed at large accounts covering refineries, offshore platforms, and drilling rigs. Marine business focuses on ocean fleets worldwide.

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

Distribution Channels

HCC's product distribution sources vary by line of business. The majority of the company's business is written through outside brokers, agents, and third-party administrators 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 subsidiaries of HCC focus principally on professional liability and other specialty lines.

Financial Analysis

Profitability

See Key Rating Issues section.

Investments and Liquidity

See Key Rating Issues section.

Reinsurance Protection and Credit Quality

Historically, HCC 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 lines of business (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 2008, the company ceded approximately 18% of its gross premiums to reinsurers, down significantly from 53% at year-end 2002. HCC's strategy is to increase its retention in 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.

Reinsurance Recoverables

(\$ Mil.)

| | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|-------|-------|-------|-------|-------|
| Paid Losses | 59 | 81 | 92 | 83 | 87 |
| Unpaid Losses | 469 | 437 | 517 | 624 | 479 |
| Incurred But Not Reported Losses | 350 | 337 | 395 | 607 | 469 |
| Unearned Premium | 207 | 180 | 180 | 204 | 275 |
| Total Recoverable | 1,085 | 1,035 | 1,184 | 1,518 | 1,311 |
| Affiliates | 38 | 34 | 32 | 26 | 1 |
| Net Recoverables | 1,047 | 1,001 | 1,152 | 1,493 | 1,309 |
| Total Recoverables/Policyholders' Surplus (%) | 68.9 | 70.3 | 105.9 | 157.1 | 175.4 |
| Net Recoverables/Policyholders' Surplus (%) | 66.5 | 68.0 | 103.0 | 154.4 | 175.2 |
| Provision for Reinsurance | 42 | 24 | 52 | 79 | 67 |
| Total Recoverables/(PHS + Provision for Re) (%) | 67.1 | 69.2 | 101.2 | 145.2 | 161.0 |
| Net Recoverables/(PHS + Provision for Re) (%) | 64.8 | 66.9 | 98.4 | 142.7 | 160.9 |

PHS – Policyholders' surplus. Note: Statutory accounting principles.

Source: HCC Insurance Holdings Group.

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's reinsurance recoverables totaled \$1 billion at Sept. 30, 2009.

HCC has reported favorable reserve development since 2006, and adverse development in 2003–2005 was primarily due to reinsurance commutations.

Reserve Adequacy and Development

At Sept. 30, 2009, HCC's GAAP consolidated gross loss reserves were \$3.5 billion, and net loss reserves were \$2.6 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 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 net prior-year reserve development of \$36.6 million in the first nine months of 2009 resulted from a re-estimation of its net exposure to 2005 hurricanes and the London market professional indemnity business for 2005 and prior accident years. As a result of uncertainty in financial markets, HCC increased 2008 accident-year reserves principally for D&O liability and surety business written in 2007, while decreasing reserves in earlier accident years for these products.

HCC discloses the low and high end of reserve ranges estimated by its actuaries for each major line of business, relative to recorded reserves in its form 10-K filings. HCC consistently maintains total consolidated net reserves above the total actuarial point estimate but within the actuarial range.

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 reserve adequacy in HCC's property/casualty subsidiaries for its longer-tail lines at year-end 2008.

Capitalization

See Key Rating Issues section.

Financial Leverage and Balance Sheet Quality

See Key Rating Issues section.

Debt-Servicing Capabilities

Fitch views HCC's debt-servicing capabilities and liquidity position as solid. The company generates strong cash flow with average annual cash from operations (CFO) of \$588 million during the three-year period ending Dec. 31, 2008 (ex-cash from commutations). Through Sept. 30, 2009, CFO totaled \$418 million.

Interest coverage has steadily improved over the past five years and was very strong at 34x through Sept. 30, 2009. Fitch expects HCC's GAAP earnings-based interest coverage ratio to remain solid.

HCC's interest coverage ratio may decline modestly in 2010 with the issuance of long-term debt, but will be somewhat offset by the redemption of its outstanding convertible debt.

HCC can receive up to \$199.2 million in dividends from its U.S. insurance subsidiaries in 2009, which provides additional liquidity to service its debt payments. Other liquidity sources include HCC's \$575 million revolving loan facility along with \$700 million remaining under its \$1 billion shelf registration.

Cash Flow and Liquidity

(\$ Mil.)

| | 9/30/09 | 9/30/08 | 2008 | 2007 | 2006 | 2005 | 2004 |
|-----------------------------|---------|---------|-------|-------|-------|-------|-------|
| Cash Flow from Operations | 418 | 401 | 506 | 726 | 653 | 624 | 669 |
| Cash Flow from Investing | (417) | (437) | (442) | (737) | (668) | (773) | (781) |
| Cash Flow from Financing | 29 | 17 | (76) | 2 | (11) | 153 | 86 |
| % Liquid Assets/Liabilities | 91 | 82 | 85 | 84 | 71 | 63 | 56 |

Note: GAAP accounting.
Source: 10-Q filings.

Capitalization and Interest Coverage

(\$ Mil.)

| | 9/30/09 | 9/30/08 | 2008 | 2007 | 2006 | 2005 | 2004 |
|----------------------------------|---------|---------|-------|-------|-------|-------|-------|
| Total Capital | 3,432 | 2,921 | 2,984 | 2,763 | 2,348 | 1,993 | 1,628 |
| % Total Debt | 13 | 13 | 12 | 12 | 13 | 15 | 18 |
| % Common Equity | 87 | 87 | 88 | 88 | 87 | 85 | 82 |
| % Adjusted Debt/Tangible Capital | 17.1 | 17.9 | 16.2 | 16.1 | 18.5 | 20.0 | 24.2 |
| EBIT/Interest Expense(x) | 34.1 | 24.5 | 24.0 | 36.4 | 29.0 | 19.9 | 20.3 |

Note: GAAP accounting.
Source: 10-Q filings.

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