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Company Article

Houston Casualty Co.

FSR: AA/Stable/- FSR
Date: 25-Jul- United States
03

CCR: AA/Stable/- CCR
Date: 18-Jul- Sector: Property/Casualty
01 Insurance



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Contact(s): Siddhartha Ghosh, New York (1) 212-438-1466;
siddhartha_ghosh@standardandpoors.com

Contact(s): John Iten, New York (1) 212-438-1757;
john_iten@standardandpoors.com

Holding Company:
HCC Insurance Holdings Inc.

Counterparty Credit Rating

Local Currency
A/Stable/--

**Operating Companies Covered By
This Report**

Financial Strength Rating

Local Currency
AA/Stable/--

Major Rating Factors

Strengths:

- Very strong competitive position, with market leadership in the niche medical stop-loss business.
- Very strong operating results, driven primarily by superior underwriting performance.
- Very strong consolidated capital adequacy.

- Conservative financial leverage and fixed-charge coverage ratios.

Weaknesses:

- The recent growth in the director's and officer's/errors and omissions lines increases the group's exposures to longer-tail liabilities.
- Dependence on reinsurance recoverables, though reduced significantly from historical levels.
- The rapid growth through acquisitions in recent years has created integration risks, though the relatively small size of these deals partially mitigates this risk.

■ Rationale

The insurer financial strength ratings on the members of the Houston Casualty Insurance Group (HCC) are based on HCC's very strong competitive position, very strong operating performance, very strong capital adequacy, relatively short-tail risk profile with a low probability of material adverse reserve development, and strong financial flexibility. Partially offsetting these positive rating factors are HCC's increased balance-sheet risk from its longer-tail director's and officer's (D&O) business, relatively high dependence on reinsurance, and the potential integration risks associated with its frequent though modest-sized acquisitions.

HCC has a very strong competitive position in its target specialty markets in the U.S. and abroad. The company has built a strong brand name in the commercial property/casualty insurance market by offering short-tail specialty lines such as medical stop-loss, aviation, D&O/errors and omissions (E&O), surety, and property/marine/energy. Since 2002, HCC has gradually increased its insurance risk profile by expanding into medium- to long-tail, more ratings-sensitive lines, particularly D&O liability and professional liability (primarily E&O). HCC's expansion into these lines has been a major contributor to its strong growth in recent years. The company also expanded into credit insurance and writes a relatively small amount of residual-value

insurance and mortgage reinsurance.

HCC's operating results have been historically very strong, as its superior underwriting results in each of the past five years, when the property/casualty industry has been under significant price competition, demonstrate. HCC's GAAP combined ratio was very strong at 84.9% in 2009, modestly improved from 85.4% in 2008, despite the soft pricing environment. Excluding prior-year favorable reserve developments, HCC's GAAP combined ratio was 87.5% in 2009, 89.5% in 2008, and 84.7% in 2007, indicating that its significant reserve releases in recent years did not materially affect earnings. HCC's GAAP return on revenue (ROR) was also very strong at 22% compared with 18.8% in 2008. In terms of underwriting results, as measured by statutory combined ratios, HCC has outperformed the U.S. property/casualty commercial lines sector for each of the past five years (2005-2009).

HCC's consolidated year-end 2009 capital adequacy on pro forma basis (including HCC Life Insurance Co. and international subsidiaries) was redundant at the 'AA' rating category and better than in the previous year. Historically, the group has maintained a very strong level of capital adequacy, which stemmed from its superior underwriting profitability across all product lines and lower volatility from its conservative investment portfolio compared with those of many of its similarly rated peers.

Standard & Poor's Ratings Services views HCC Insurance Holdings Inc.'s (HCC Insurance Holdings) financial flexibility as very strong. The company's capital structure is very conservative, with debt to capital at a very modest 10.3% at year-end 2009 compared with 12.6% in 2008 and 12.9% in 2007. In addition, the consolidated GAAP fixed-charge coverage ratio was very strong at 25.7x at year-end 2009 compared with 23.2x in 2008 and 36.3x in 2007.

HCC's diversified financial products unit writes D&O, E&O, and fiduciary liability coverages for a broad range of entities, which also includes financial institutions and intermediaries. Since 2002, the company increased its writings in this sector, exposing it to higher potential

volatility related to large claims from sources such as securities litigation. At year-end 2009, HCC had a number of subprime-related claims that originated during the recent dislocation of the global financial markets. However, the average net policy limits of these claims were relatively low, averaging \$11.3 million for Side-A and \$9.1 million for non-Side A, which partially mitigates this concern. Nevertheless, the group is still exposed to the risk that ultimate settlements on these claims might be significantly higher than those expected, as some of these could take several years to settle.

Historically, HCC's exposure to reinsurance recoverables has been a concern for Standard & Poor's because of the risk of potential uncollectibility issues from its reinsurers. The group's reinsurance utilization historically has been higher than many of its peers'. However, the group's ratio of reinsurance recoverables to surplus has significantly decreased in recent years, as HCC has retained more of this business because of its strong profitability. Also mitigating this concern somewhat is the high quality of the reinsurers backing these recoverables. The group's premium retention has averaged about 81% since 2006, up significantly from 29% in 2000.

Although HCC has a history of successful acquisitions, the fast pace of acquisitions in recent years has created integration risks. However, management's extensive experience in this area mitigates this risk. HCC has concentrated mostly on multiple small acquisitions, thereby decreasing its exposure to potential problems with any one acquisition.

■ Factors Specific To Holding Company

HCC Insurance Holdings has a strong ability to service its debt obligations and meet its other cash requirements, principally dividends to shareholders (\$57.4 million in 2009) and interest expense (\$16.2 million in 2009). The company also used \$35.5 million to repurchase shares of its common stock in 2009 as part of its now-largely-completed share-repurchase program. Its capital structure remains conservative, with the consolidated debt-to-capital ratio at a very modest 10.3% at year-end 2009, a decrease from 12.6% at year-end 2008 and 12.9% at year-end 2007. We

expect that the company will maintain its financial leverage at or below a conservative 25% for the medium term. Also, HCC's GAAP interest coverage remained very strong at 25.7x at year-end 2009, a slight improvement from 23.2x in 2008. HCC's statutory interest coverage, which is the ratio of holding-company interest expense to the dividend capacity of its insurance subsidiaries, also remained very strong at 9.5x at year-end 2009, a moderately improvement from 8.3x at year-end 2008.

As of Dec. 31, 2009, HCC has \$300 million of senior notes outstanding, which will mature on 2019, and it has an estimated interest expense of \$19 million. In addition, the holding company has \$575 million of bank credit facility available as of year-end 2009. HCC also has \$152 million in standby letters of credit available, supporting HCC's two Lloyd's syndicates. In addition, the significant amount of cash and short-term investments in HCC's investment portfolio—\$940 million at year-end 2009 and \$525 million at year-end 2008—strongly support its liquidity needs.

Cash and short-term investments at the holding company were \$90 million at year-end 2009, which will cover one year of holding-company expenses related to shareholders' dividends and the interest expenses on its senior debt. The ordinary dividend capacity from the operating subsidiaries of HCC is about \$218 million in 2010, which compares with \$199 million in 2009 and \$161 million in 2008. In addition, HCC's substantial undrawn borrowing capacity under its bank revolving credit facility of \$575 million strongly supports any short-term liquidity needs of the group. This revolving loan facility expires in December 2011.

HCC's common stock has been consistently trading above its book value throughout the past couple of years, suggesting its accessibility of the capital markets if needed for any future financing for potential acquisitions or otherwise. Also demonstrating HCC's financial flexibility is its recently raised \$300 million senior notes in late 2009 following \$150 million of common equity capital raised in 2005 and \$100 million of new equity capital in 2004.

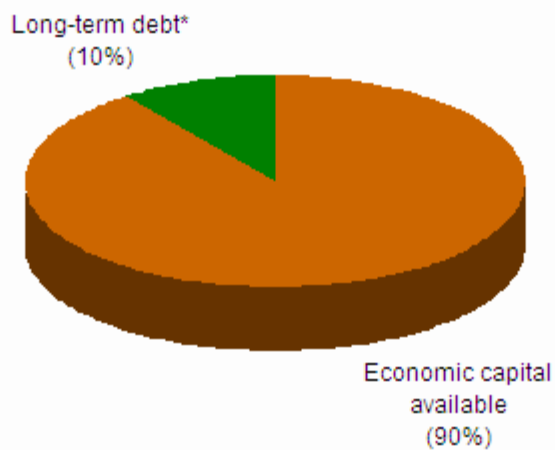
Table 1

HCC Insurance Holdings Inc./Financial Statistics					
	--Year ended Dec. 31--				
	2009	2008	2007	2006	2005
Debt to total capital (%)	10.3	12.6	12.9	15.1	17.1

Debt plus preferred (including hybrids) to total capital (%)	10.3	12.6	12.9	15.1	17.1
GAAP interest coverage (x)	25.7	23.2	36.3	29.3	24.5
GAAP fixed-charge coverage (x)	25.7	23.2	36.3	29.3	24.5
Statutory interest coverage (x)	9.5	8.3	11.0	5.3	6.3
Statutory fixed-charge coverage (x)	9.5	8.3	11.0	5.3	6.3

HCC Insurance Holdings Inc. Consolidated Capital Analysis As Of Dec. 31, 2009

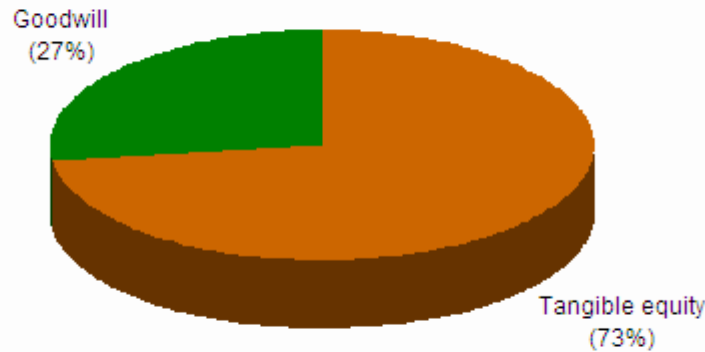
Total capital: \$3.4 billion



*Includes hybrids as debt, off-balance-sheet pension, and net present value of operating leases.

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HCC Insurance Holdings Inc. Quality Of Capital Analysis As Of Dec. 31, 2009 Economic capital available: \$2.7 billion



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■ Outlook

The stable outlook reflects Standard & Poor's expectation that HCC will sustain its current competitive position in its target specialty niche markets and increase profits through strong cycle management, strong risk controls, and good pricing discipline. We expect that HCC will increase its gross premium volume moderately in the next couple of years, both organically and through potential small strategic acquisitions, as it has in the past few years. The group's consolidated operating performance will likely remain very strong through strong underwriting results and stable investment income from its conservative investment portfolio. Standard & Poor's expects that HCC's consolidated GAAP combined ratio will be at or better than 90% and that its GAAP return on revenue (ROR) will be in line with those of similarly rated peers at more than 15% in the next couple of years. Also, HCC's consolidated operating company capital adequacy—based on our capital model—will likely remain very strong in the next couple of years. Standard & Poor's also expects that HCC will maintain conservative financial leverage at or less than 25% for the intermediate term.

It is unlikely that we will raise the ratings on HCC in the intermediate term, considering its narrowly focused specialty product lines with limited scale when compared with those of similarly rated peers. On the other hand, if HCC does not meet our expectations in terms of operating earnings or competitive position in the next couple of years, there could be negative rating implications.

■ Competitive Position: Very Strong, Boosted By Strategic Acquisitions And Strong Underwriting Discipline

The companies in the HCC group are wholly owned subsidiaries of HCC Holdings, a U.S.-based property/casualty insurance holding company. Standard & Poor's considers Houston Casualty Co., Avemco Insurance Co., U.S. Specialty Insurance Co., , Perico Life Insurance Co. and HCC Life Insurance Co. to be core to the HCC group, and as such, these entities are rated the same. The financial strength ratings on the other group members—American Contractors Indemnity Co., Houston Casualty Co. Europe Seguros & Reaseguros S.A. (HCC Europe), HCC Reinsurance Co. Ltd., United States Surety Co., and HCC International Insurance Co. PLC (HCCI)—are based on unconditional guarantees from Houston Casualty Co., HCC Insurance Holdings' primary insurance subsidiary. In addition to insurance companies, the group owns several underwriting agencies.

Table 2

Houston Casualty Insurance Group/Selected Statistics					
	--Year ended Dec. 31--				
(Mil. \$)	2008	2007	2006	2005	2004
Total revenue	1,159.3	1,100.6	1,059.1	916.7	757.1
Net income	260.8	254.1	220.3	58.7	51.4
Combined ratio (%)	79.5	78.1	80.9	94.1	92.2
Return on revenue (%)	32.9	30.7	25.9	10.3	11.1
Total assets	4,207.8	3,940.6	3,506.1	3,027.0	2,213.1
	1,	1,	1,	966.5	747.2

Statutory surplus	574.0	472.3	118.2		
Capital adequacy ratio (%)	N.A.	N.A.	N.A.	161.2	176.2
N.A.--Not available.					

Table 3

Houston Casualty Insurance Group/Business Statistics					
	--Year ended Dec. 31--				
(Mil. \$)	2008	2007	2006	2005	2004
Other liability	531.0	459.8	491.0	503.8	335.7
Surety	186.5	186.9	147.7	116.4	61.0
Aircraft (all peril)	135.3	145.8	166.4	129.8	143.9
Group accident and health	32.0	39.9	56.3	76.7	128.0
Ocean marine	30.6	56.3	68.3	47.2	(15.7)
Credit	17.3	12.2	10.4	1.7	0.0
Other premiums	67.5	75.7	56.9	52.0	142.1
Total net premiums written	1,000.2	976.7	996.8	927.6	795.1
Total change in net premiums written (%)	2.4	(2.0)	7.5	16.7	(99.9)

Standard & Poor's believes that HCC has a very strong competitive position in its target specialty markets in the U.S. and abroad. The company has a strong brand name in the commercial property/casualty insurance market by offering short-tail specialty lines, such as medical stop-loss, aviation, D&O/E&O, surety, and property/marine/energy. Since 2002, HCC has gradually increased its insurance risk profile by expanding into medium- and longer-tail, more ratings-sensitive lines, particularly D&O and professional liability (primarily E&O). The company also expanded into credit insurance and writes a relatively small amount of residual value insurance and mortgage reinsurance. The business strategy is principally based on superior underwriting profitability and by providing low to moderate risk limits. HCC's expansion into these lines has been a major contributor to its strong growth in recent years.

HCC's premium grew over the past few years through

many small acquisitions of underwriting teams, insurers, and producers specializing in the same product lines as in its current portfolio. During 2007-2009, HCC made eight small acquisitions, ranging in value from \$4 million to \$43 million. Depending on the expected profitability or the volatility of the acquired business or business platform, the company either uses its own insurance companies to write the business produced by its affiliated underwriting agencies or it places business with other carriers and benefits from the brokerage fees and commissions.

HCC's growth strategy has generally focused on acquiring specialty underwriting agencies. As the group becomes more comfortable with the performance of the business the agencies produce, it transfers the business to its own insurance companies and keeps the majority of the profits. This strategy provides HCC with significant benefits, including control of the quality of the business at the source, applying the same underwriting standards as those of HCC over much of its product distribution and less reliant on reinsurer availability or the reinsurance costs.

HCC's gross written premium increased a modest 2% to \$2.56 billion in 2009 from \$2.5 billion in the previous year. However, HCC's net written premium was down slightly to \$2.046 billion in 2009 from \$2.06 billion in 2008. Until 2008, HCC followed a strong growth track of its net premium written with 4% growth in 2008 following 10% in 2007, 21% in 2006, and 36% in 2005. Much of the group's net premium growth in recent years stemmed from HCC retaining more of the business its affiliated agencies produced. It did so due to the strong pricing and terms and conditions in 2002-2006 and because its rapidly growing capital base during that period supported such growth. The premiums HCC cedes to reinsurers have since declined—to about 20% in the last couple of years from a much higher 71% in 2000. Standard & Poor's expects HCC's retention rate will remain at its current level of about 80% over the next couple of years. With increased business retention, HCC assumes higher underwriting risks compared with its historical levels of ceding a substantial amount of business to third-party

reinsurers. However, partially mitigating this risk are HCC's strong underwriting standards, a solid track record of strong underwriting profitability, low to moderate risk limits, and a significant capital base (GAAP equity) of \$3.0 billion.

HCC's diversified financial product lines segment has performed very well since 2002, and it is the group's largest business segment, generating 45% of its net premiums at year-end 2009 compared with 42% in 2008 and 39% in 2007. The recent growth in this sector was helped by increased pricing because of higher demand for these products following the recent financial market dislocations. HCC's premium retention rate for this segment remained at about 80% in 2009, a slight dip from 83% in 2008, as the pricing for these products is declining after a temporary uptick in 2008.

The medical stop-loss business constituted a significant 31% of its overall net premium written in 2009, which remained at the same level as in the past couple years and has been one of the major contributors to the group's overall businesses over the past few years. Group life, accident, and health, which is dominated by medical stop-loss coverage, is HCC's second-largest line of business. It accounted for 39% in 2009, a slight increase from 38% in 2008. The recent growth in this line was attributable to the acquisition of Multi National Underwriters, a managing general underwriter that writes international accident and health business through HCC's syndicate operations at Lloyd's of London. HCC is the U.S. market leader in medical stop-loss insurance, and this is the company's largest single product line. It writes this business through HCC Life Insurance Co. (HCC Life) and HCC Life's subsidiary, Perico Life Insurance Co.

HCC Life enhanced its leadership position in October 2006 when it acquired the assets of the Health Products Division of Allianz Life Insurance Co. of North America for a cash consideration of \$140 million. The Health Products division's operations expanded HCC's already strong position in medical stop-loss insurance for self-insured corporations and groups. The unit also writes medical excess insurance for HMOs as well as providing excess

insurance for integrated delivery systems and excess medical reinsurance to small and regional insurance carriers. More recently, HCC has expanded its presence in the surety bond market through the purchase of several modest-size surety writers.

HCC's aviation business constituted 6% of its 2009 net written premium, a modest decline from 7% in the last couple of years because of competitive price softening during this period. HCC's London Market account, which is largely property and energy businesses, constitutes about 5% of its overall net premium, which also declined modestly in 2009, primarily because of higher reinsurance utilization, which is aimed at mitigating higher severity from potential catastrophe events.

Diversification

HCC has a well-diversified and uncorrelated product mix distributed in its key market segments in the U.S. and European countries. Though predominantly a U.S. insurer, the company's non-U.S. businesses generate about 19% of the group's total revenues.

HCC is the U.S. market leader in medical stop-loss insurance, its largest single line. HCC maintains a strong position in general aviation but avoids the highly competitive major airline segment in favor of smaller risks. HCC is also well established in property/marine/energy, kidnap and ransom, professional liability, and event cancellation. A key competitive advantage is its control over much of its distribution network through the ownership of specialized underwriting agencies.

Prospective

Standard & Poor's expects that HCC's gross written premium will increase moderately through organic growth from its recent acquisitions, especially in the London market business, group life and accident and health business and the public risk business. The retention of business will remain at about 80% for the next couple of years, as the underlying business

remains very profitable and less volatile in terms of earnings. We expect that growth in net premiums will be similar to that of gross premiums, as we do not expect the company to further increase the percentage of premiums written that it retains for its own account. If pricing deteriorates more than expected, HCC likely will cut back on the amount of business it writes and increase its use of reinsurance to maintain prudent underwriting guidelines and profitability at its insurance companies.

■ Management And Corporate Strategy: Provides Group With Strong Oversight And Distribution Control

HCC's growth strategy has generally been to supplement its organic growth by acquiring small specialty insurers and underwriting agencies. Although one of HCC's main strategies is to maintain a leadership position in its niche markets, Standard & Poor's expects HCC's business mix to shift over time in response to changing market conditions or significant acquisition opportunities.

Once owned by HCC, acquired insurers increase their net premium written by reducing the amount of reinsurance they use. A good example of the company's growth strategy is its recent expansion into the surety market. It started with the purchase of HCC Europe, a writer of performance and construction bonds, in 2002. American Contractors Indemnity Co., a Los Angeles-based writer of small surety bonds, was acquired in 2004. In the first quarter of 2005, HCC purchased Maryland-based United States Surety Co., and in mid 2005, it completed the acquisition of U.K.-based DeMontfort Insurance Group (renamed HCCI). In March 2009, HCC acquired Surety Co. of the Pacific, which should add \$20 million of premiums.

Following the purchase of an agency, HCC transfers the business to its own insurance companies once it becomes comfortable with the book the agency controlled. Typically, HCC looks for intermediaries that produce lines

of business that HCC already writes or that complement its own underwriting expertise. This strategy provides HCC with significant benefits, including control over much of its product distribution and less reliance on dividends from the insurance companies to cover the holding company's recurring cash requirements, which historically it has met with the fee income the agencies and intermediaries generated. Although historically the fee income component of the overall revenue has been significant, the group's increased business retention has shifted its strategy to depend more on premium revenue as opposed to fee income. With the divestment of its wholly owned reinsurance broker, Rattner Mackenzie Ltd., to Guy Carpenter in October 2009, HCC's future strategy is to concentrate on its core businesses.

As of May 2009, John Molbeck has been appointed to be the new CEO succeeding Mr. Bramanti, who retired and remains on the board. Mr. Molbeck has been with HCC for many years and most recently had been the President and Chief Operating Officer prior to his current role as the CEO. Under Mr. Molbeck's leadership, there has been virtually no change in business or financial strategies, with the principal focus remaining on underwriting discipline and strategic growth through acquisitions. Frank Bramanti was part of HCC's senior management team for many years before coming out of retirement to assume the CEO position in 2006. In addition, Tobin Whamond is a new member of the senior management team; Mr. Whamond joined HCC as executive vice president in May 2009 and became CFO effective August 2009.

Operational management

Management is committed to producing strong underwriting profit in each of its lines of business, which it accomplishes through strict underwriting guidelines and effective use of reinsurance. HCC does much of its underwriting through its affiliated managing general underwriters, which is why HCC structures each acquisition to ensure that senior management stays on board. The group takes a decentralized underwriting approach, with each business unit viewed as a profit

center that can make independent decisions about risk selection and pricing, with an oversight at the corporate headquarters. HCC strictly monitors and reinforces underwriting results through an incentive-compensation plan that is based on underwriting profitability. Significant treaty and facultative protection supports most underwriting.

Financial management

HCC manages its balance sheet conservatively, reflecting management's overriding commitment to protect the group's capital and surplus. This objective established the underwriting and reinsurance culture that is prominent in the organization today. Its operating-company capitalization has historically been very strong, though it dipped temporarily in 2003 because of the exceptionally strong premium growth that year. Statutory surplus also dropped in 2006 as a result of the requirement under statutory accounting principles to write off the goodwill associated with the acquisition of the Allianz Life Health Products division. Reserve adequacy has historically been adequate. HCC assumes very little risk in its investment portfolio, with nearly the entire portfolio invested in high-quality, fixed-income securities. Financial leverage and coverage ratios are conservative for the rating. The catastrophe risk tolerances are relatively low, with internal tolerances from such losses because of any major catastrophe events at one-quarter of earnings, which has been the track record for the past few major catastrophe events, including the Sept. 11, 2001, terrorist attacks and the major hurricane-related losses in 2004, 2005, and 2008. The company also maintains a tight expense structure, as its relatively low expense ratio demonstrates. This ratio was 24%-26% over the past five years (2005-2009), which compares favorably with that of many of its peers.

■ Enterprise Risk Management: History Of Effective Underwriting Cycle Management

Standard & Poor's views HCC's enterprise risk management (ERM) efforts as adequate with a positive

trend. This means that upon clear evidence of successful implementation of strategic risk management initiatives—including decision making processes through the economic capital model—we could revise our assessment of the group's ERM to strong within the next two years. HCC has exercised strong risk controls throughout the organization, as its exceptional track record of underwriting, which it effectively controls at the source of its businesses, demonstrates. The organization's ERM program is developing nicely, with well-seasoned practices across all essential areas of risk controls, particularly underwriting, pricing, cycle management, operational, market, and credit risk. HCC has an excellent track record of effectively managing the level of underwriting risk it assumes and generating strong and consistent underwriting profits. HCC's flat organizational structure has risk ownerships assigned to individual managers, with an oversight from an enterprise-risk committee and strategic guidance from the board of directors. Despite the challenging macroeconomic environment and the continuing soft market cycle, HCC is well positioned with its excess capital base, ample liquidity, and rock solid investment portfolio to withstand the current underwriting cycle.

The company's primary risk tolerance objective is to protect its capital base from any decline and to limit exposure to a single event to no more than one-quarter of earnings. Senior management has a strong process in place for determining each business unit's risk tolerance for each line, which leads to agreement on policy limits, retention amounts, required level of reinsurance protection, and incentive compensation.

The company has effectively managed the property/casualty underwriting cycle through its control of the underwriting agencies that generate much of its business and uses reinsurance judiciously to protect its balance sheet. The primary event-risk exposure for HCC is the natural catastrophe risk it assumes through the writing of property, marine, and energy risks, principally in the London market. HCC uses a comprehensive reinsurance program to protect itself from catastrophe-

exposed business. If reinsurance is not available or is too expensive, the company cuts back on the amount of business it writes.

Credit risk has been increasing as HCC expands its D&O and surety businesses. The decline in credit risk associated with reinsurance recoverables has mitigated this. Integration risk is of some concern because HCC's growth strategy includes acquiring small underwriting agencies and insurers. The company has a good track record in this area.

■ Accounting

The consolidated financial statements of the main holding company, HCC Insurance Holdings, are filed quarterly with the SEC on a U.S. GAAP basis. The domestic insurance subsidiaries file financial statements with state insurance regulators, prepared in accordance with statutory accounting principles. The holding company received an unqualified opinion from its auditor, PricewaterhouseCoopers LLP, in 2009.

In December 2006, following the board of directors' investigation into HCC's past practices related to granting stock options, the group restated its consolidated financial statements for the years ended Dec. 31, 2005, 2004, and 2003, for the quarter ended March 31, 2006, and for all quarters in 2005 and 2004. The cumulative net decrease in shareholders' equity as of Dec. 31, 2005, was a modest \$3.3 million. In addition, the company concluded that it had a material weakness in internal control over financial reporting. Specifically, the company did not maintain adequate controls to prevent or detect management override by certain former members of senior management related to its stock-option granting practices and procedures. This resulted in a misstatement of stock-based compensation expense, additional paid-in capital, and related income tax accounts and disclosures. The company remediated this material weakness in the fourth quarter of 2006 and did not have a material weakness as of Dec. 31, 2006.

In 2007, HCC incurred 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, HCC used certain available-for-sale fixed-income securities, denominated in British pound sterling, to hedge foreign-currency exposure on certain insurance reserves and other liabilities, denominated in the same currency. The group 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, the company reversed \$13.4 million of cumulative unrealized exchange rate gains and recorded this reversal as a charge to the gain or loss from the currency conversion account, with an offsetting credit to other comprehensive income. HCC reported the 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, HCC sold these available-for-sale securities, and it realized the \$13.4 million of embedded cumulative currency conversion gains. This gain was included in the net realized investment gain or loss line of the consolidated statements of earnings. The offsetting effect of these transactions had no impact on 2007 consolidated net earnings.

■ **Operating Performance: Consistently Very Strong, Fueled Mainly By Strong Underwriting Results Despite The Current Competitive Environment**

HCC's operating results have been historically very strong, as its superior underwriting results in each of the past five years, when the property/casualty industry has been under significant price competition, demonstrate. HCC's GAAP combined ratio was very strong at 84.9% in 2009, modestly improved from 85.4% in 2008, despite the soft pricing environment. Excluding prior-year favorable reserve developments, HCC's GAAP combined ratio was 87.5% in 2009, 89.5% in 2008, and 84.7% in 2007, indicating that its earnings in recent years were not

materially influenced by large reserve releases, as was the case for many of its peers. HCC's GAAP ROR was also very strong at 22% from 18.8% in 2008. In terms of underwriting results, HCC has outperformed the U.S. property/casualty commercial lines sector for each of the past five years (2005-2009) as measured by statutory combined ratios. The company's statutory combined ratio was 86.4% in 2009 compared with the sector average of 100.6% in 2009 (as per A.M. Best estimate). HCC's GAAP expense ratio averaged 25% over the past five years and compares very favorably with those of most of its peers.

Table 4

Houston Casualty Insurance Group/Operating Statistics					
	--Year ended Dec. 31--				
(Mil. \$)	2008	2007	2006	2005	2004
Total revenues	1,159.3	1,100.6	1,059.1	916.7	757.1
Pretax operating income (excluding realized gains)	381.4	337.5	274.1	94.3	83.9
Net income	260.8	254.1	220.3	58.7	51.4
Return on revenue (%)	32.9	30.7	25.9	10.3	11.1
Return on assets (%)	6.4	6.8	6.7	2.2	2.7
Return on statutory surplus (%)	17.1	19.6	21.1	6.9	8.0
Loss ratio (%)	48.8	48.3	52.9	64.3	63.9
Expense ratio (%)	30.7	29.8	27.9	29.8	28.3
Combined ratio (%)	79.5	78.1	80.9	94.1	92.2
Operating ratio (%)	40.5	34.5	29.7	13.9	15.6
Portfolio performance					
Net investment income	193.6	123.1	101.0	68.1	54.4
Net yield (%)	5.3	3.8	3.7	3.2	3.7
Net capital gain or loss	(39.5)	94.0	(65.5)	45.1	37.6
Portfolio composition					
Cash and short-term investments (%)	3.7	7.3	8.5	16.0	20.5
Bonds (%)	83.9	77.3	75.2	70.3	69.7
Preferred and common stocks	9.3	11.0	11.5	10.0	7.5

(%)					
Real estate and mortgage loans (%)	0.2	0.3	0.3	0.4	0.6
Other invested assets (%)	2.8	4.1	4.5	3.3	1.8
Invested assets to total assets (%)	88.8	89.0	83.5	84.7	79.3
Average maturity of bond portfolio (years)	6.5	6.4	5.8	5.4	7.2

Historical

HCC's insurance operations have historically reported combined ratios well less than 100% with the exception of 2001, which was adversely affected by gross \$141 million losses (net \$35 million) related to the Sept. 11, 2001, event and \$37 million gross (\$19 million net) reserve charges primarily related to HCC's exit from its workers' compensation business. Despite significant hurricane losses in 2005 and 2004, HCC performed very well, with GAAP combined ratios of 93.2% and 90.5%, respectively. The hurricane losses added 4.8 and 2.3 percentage points to the 2005 and 2004 loss ratios, respectively.

HCC's operating performance has historically benefited from the fee income generated by its agencies and intermediaries, though this has become less important in recent years as the group retains more of the businesses these agencies produced. However, the declines in fee incomes in recent years have been more than offset by increased underwriting profits from the retained businesses. HCC's GAAP ROR averaged 21% over the past five years (2005-2009).

Prospective

Standard & Poor's expects that HCC's operating performance will remain very strong in the next couple of years, with a consolidated GAAP combined ratio near 90%. In addition, we expect that its GAAP ROR will be at least 15% over the next couple of years. Standard & Poor's believes that HCC's strong cycle-management strategy—with strong risk controls and superior

underwriting capabilities—will drive future profitability at or near current levels. We expect that management will maintain strong underwriting and pricing discipline in the current environment and focus on organic growth through underwriting profitability and maintain a minimal risk orientation in its investment portfolio.

■ Investments And Liquidity: Conservative, With Minimal Subprime Exposure

HCC has a conservative investment strategy and manages its consolidated investment portfolio as determined from its investment guidelines, with less than \$5 million of equity or alternative investment exposures. The investment portfolio is very conservative, with no equity or alternative investment exposures as of year-end 2009, reflecting the short-tail nature of HCC's business. As of Dec. 31, 2009, 85% of HCC's consolidated investment portfolio was in fixed-income securities (45% taxable with average rating 'AA+' and 40% tax-exempt with average rating 'AA') and with the remainder 15% in short-term investments. HCC's global fixed-income portfolio composition as of Dec. 31, 2009, was 49% in 'AAA', 34% in 'AA', 14% in 'A', 2% in 'BBB', and only 1% speculative-grade securities with an overall average credit rating of 'AA+', which is of high quality. The average duration of HCC's fixed-income portfolio was 4.9 years at year-end 2009, up slightly from 4.8 years at year-end 2008, implying a moderate amount of interest rate risks in its fixed-income portfolio.

Table 5

Houston Casualty Insurance Group/Financial Statistics					
	--Year ended Dec. 31--				
(Mil. \$)	2008	2007	2006	2005	2004
Total assets	4, 207.8	3, 940.6	3, 506.1	3, 027.0	2, 213.1
Statutory surplus	1, 574.0	1, 472.3	1, 118.2	966.5	747.2
Capital adequacy ratio (%)	N.A.	N.A.	N.A.	161.2	176.2
Loss and loss adjustment expense reserves/statutory	1.1	1.1	1.4	1.2	1.0

surplus (x)					
Common stock to surplus (%)	22.1	26.2	29.3	23.5	13.6
Reinsurance utilization ratio (%)	23.7	23.2	23.3	31.7	44.9
Reinsurance recoverables to surplus (%)	54.1	64.2	91.6	133.7	135.9
Underwriting cash flow ratio (%)	143.7	155.8	205.4	234.3	197.9
Operating cash flow ratio (%)	152.7	152.9	187.1	223.9	196.0
N.A.--Not available.					

As evidence of HCC's conservative investment strategy, HCC experienced a very modest \$17 million of other-than-temporary impairment losses during the recent financial market downturn during 2008-2009, when most of its peers realized significant levels of such losses. HCC generally keeps a high level of cash and short-term investments, which amounted to about \$940 million at year-end 2009 up from \$525 million in 2008. The group reported a net realized investment gain of a modest \$12.1 million at year-end 2009 compared with a net realized loss of \$16.8 million at year-end 2008.

HCC has a modest amount of commercial mortgage-backed securities (CMBS) in its fixed-income portfolio, which was 3.1% of the investment portfolio at year-end 2009, down slightly from 3.4% at year-end 2008. Prior to the recent turmoil in the global financial markets in 2008, HCC had some exposures in alternative investments, which were primarily various fund-of-funds hedge funds. The fair value of this alternative portfolio was approximately \$160 million at year-end 2007. Following the recent financial market decline in late 2008, Management decided to liquidate its entire alternative investment holdings, and the net proceeds of \$94 million from the sale were reinvested in fixed-income securities in 2009.

HCC's cash generation ability from the operating companies has been extremely strong. The operating cash flow (GAAP) was \$583 million in 2009, up 15% from \$506.0 million in 2008, driven by strong retained net income. The average statutory underwriting and operating cash flow ratios during 2004 to 2008 were 187.4% and

182.5%, respectively, for the U.S. property/casualty insurance companies. HCC's large holdings of short-term investments and the high quality of its fixed-income portfolio further enhance liquidity. In addition, HCC has a \$575 million bank credit line expiring in 2011, which was unused as of Dec. 31, 2009.

■ Capitalization: Consolidated 2009 Capital Adequacy Remained Very Strong And Redundant At The Current Rating Level

HCC's consolidated year-end 2009 capital adequacy on pro forma basis (including HCC Life and international subsidiaries) was redundant at the 'AA' rating category and better than its year-end 2008 level capital adequacy. The group has maintained a very strong level of capital adequacy on a historical basis, which was driven by its superior underwriting profitability across all product lines and lower volatility from its conservative investment portfolio compared with many of its similarly rated peers.

The group's statutory surplus grew 13.5% to \$2.1 billion at year-end 2009 from \$1.85 billion at year-end 2008. The quality of HCC's capital remains very good, as the growth has been supported by strong retained earnings, stable investment results, adequate loss reserves, and only a modest impact on its capital from a 1-in-250-year net probable maximum loss for single property catastrophe losses. Partially mitigating this concern is HCC's high level of reinsurance utilization compared with its peers', though it has decreased from its historical levels in recent years.

Reserves

Standard & Poor's believes HCC's overall reserve position is adequate, with a modest amount of redundancy based on its own review of HCC's loss reserves using data at year-end 2008. The group's predominantly short-tailed lines with a relatively quick loss-reporting pattern generally reduces the likelihood of adverse reserve developments many years after the occurrence of losses. In addition, the group has never

been a significant writer of general liability coverage, nor does it have any material asbestos or environmental exposures. The group exited the only truly long-tailed business it has written—primarily workers' compensation—in mid-2001, a few years after it entered this market.

The company writes its D&O/E&O coverages exclusively on claims-made policy forms, which generally limit the risk of adverse development in the future because these policies require that losses need to be reported fairly quickly—within a year or two after its occurrence. That said, there are potential uncertainties related to increased reserve requirements for the existing D&O/E&O claims, especially those related to subprime exposures. However, excess capital and its current adequate reserve base largely mitigate such adverse development if it were to occur. HCC has been reporting modest amount of favorable reserve developments in the past five years, with \$53.5 million in 2009, \$82.4 million in 2008, \$26.4 million in 2007, and \$6.5 million in 2006, respectively. HCC had \$25.4 million of net adverse reserve development in 2005 (about 2% on a net reserve position of \$1.5 billion), primarily as a result of the opportunistic commutation of some business in runoff, and \$30.5 million of deficiency in 2004, which was chiefly on a book of assumed accident and health business that is in runoff.

Reinsurance

HCC uses various reinsurance programs that vary by lines of business and by its internal risk tolerances. Historically, HCC's exposure to reinsurance recoverables has been a concern for Standard & Poor's because of the risk of potential uncollectibility issues from its reinsurers. The group's reinsurance utilization has been historically higher than many of its peers'. However, the group's reinsurance recoverable to surplus ratio has significantly reduced in recent years as it retained more business due to strong profitability from these businesses produced by its affiliated underwriting agencies. The premium retention averaged about 81% since 2006, up significantly from 29% in 2000. HCC's

net reinsurance recoverable to statutory surplus reduced to 48% at year-end 2009 from 57% in 2008. Also, HCC's net recoverables to GAAP equity reduced to 34% in 2009 compared with 40% in 2008.

Another mitigating factor to the group's high reinsurance utilization is the overall high credit quality of its reinsurers throughout its history. The spread of credit risk is good, with net recoverables from any one reinsurer normally constituting less than 5% of surplus, though in the short term, recoverables from a particular reinsurer can spike above this level following a large catastrophe event as was the case in 2005 because of hurricane losses. HCC has taken a proactive approach to monitoring the quality of its recoverables. HCC's strong liquidity gives the group the ability to pay claims if a recoverable dispute were to slow down reinsurance payouts.

Catastrophe exposure

The reinsurance program for catastrophe events is conservative, with the group's probable maximum loss exposure for a 1-in-250-year natural catastrophe event expected to yield net losses equal to less than one quarter of earnings. The net losses that HCC incurred from significant catastrophe losses were Hurricanes Gustav and Ike in 2008 totaled \$21 million (\$97 million gross); Hurricanes Katrina, Wilma, and Rita in 2005 totaled \$57 million net (\$358 million gross); and the four Florida hurricanes in 2004 totaled \$23 million net. These net catastrophe losses were well within HCC's risk tolerances of one quarter of earnings and are also viewed as modest at 1.2%, 6.7%, and 3.9% of its prior year-end statutory surpluses for those years, respectively. In addition to natural catastrophe exposures, the group is also exposed to potential terrorism-related events, though this exposure is limited because of the type of business HCC provides. With the passage of TRIPRA in 2007, HCC is required to offer terrorism coverage to its commercial policyholders in certain lines of business. However, HCC does not write workers' compensation, which is a major source of exposure for many commercial property/casualty

insurers. The law establishes a deductible that each insurer would have to meet before U.S. federal reimbursement would occur. For 2010, HCC's deductible under TRIPRA is about \$122.7 million. The federal government would provide reimbursement for 85% of any additional covered losses up to the maximum amount set out in the law.

■ Financial Flexibility: Strong Access To Capital Markets, With Conservative Leverage

Standard & Poor's views HCC Insurance Holdings' financial flexibility as very strong. HCC's common stock has been consistently trading above its book value throughout the past couple of years, suggesting its accessibility to the capital markets if needed for any future financing related to potential acquisitions or otherwise. HCC Insurance Holdings recently raised \$300 million senior notes in late 2009 following \$150 million of common equity raised in 2005 and \$100 million of new equity capital in 2004. The holding company capital structure is very conservative, with the debt-to-capital ratio at a very conservative 10.3% at year-end 2009 compared with 12.6% at year-end 2008 and 12.9% at year-end 2007. The consolidated GAAP fixed-charge coverage ratio was very strong at 25.7x at year-end 2009 compared with 23.2x in 2008 and 36.3x in 2007 respectively. Standard & Poor's expects that the company will maintain total financial leverage (debt and hybrid capital) at or less than 25% in the medium term.

Ratings Detail (As Of 13-May-2010)*

Holding Company: HCC Insurance Holdings Inc.

Issuer Credit Rating	
Local Currency	A/Stable/--
Senior Unsecured	
Various	A

Operating Companies Covered By This Report

Houston Casualty Co.

Financial Strength Rating	
Local Currency	AA/Stable/--
Counterparty Credit Rating	
Local Currency	AA/Stable/--

American Contractors Indemnity Co.

Financial Strength Rating	
Local Currency	AA/Stable/--
Avance Insurance Co.	

Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	AA/Stable/--
HCC International Insurance Co. PLC	
Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	AA/Stable/--
HCC Life Insurance Co.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	AA/Stable/--
HCC Reinsurance Co. Ltd.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
HCC Specialty Insurance Co.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	AA/Stable/--
Houston Casualty Company Europe Seguros & Reaseguros S.A.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
United States Surety Co.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
U.S. Specialty Insurance Co.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	AA/Stable/--

Domicile Texas

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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