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HCC INSURANCE HOLDINGS INC/DE/
Form 10-Q/A
March 02, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q/A

- Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended June 30, 2003.
- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from _____ to _____

Commission file number 001-13790

HCC Insurance Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware

76-0336636

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

13403 Northwest Freeway, Houston, Texas

77040-6094

(Address of principal executive offices)

(Zip Code)

(713) 690-7300

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12B-2 of the Act).

Yes No

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

On August 1, 2003, there were 63.7 million shares of common stock, \$1.00 par value issued and outstanding.

Explanatory Note

This amendment includes changes from the previous report to reflect the impact of a restatement due to the accounting for certain fee and commission income as described herein. Revenue and net income for the six months ended June 30, 2003 were reduced by \$13.8 million and \$8.2 million, respectively, as a result of the restatement.

HCC INSURANCE HOLDINGS, INC.

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This report on Form 10-Q/A contains certain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as "anticipate," "believe," "estimate," "expect," "intend," "plan," "probably" or similar expressions, we are making forward-looking statements. Many risks and uncertainties may impact the matters addressed in these forward-looking statements.

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

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

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(unaudited, in thousands, except per share data)

| | June 30, 2003 ----- (restated) |
|--|--------------------------------------|
| ASSETS | |
| Investments: | |
| Fixed income securities, at market (cost: 2003 - \$976,833; 2002 - \$807,772) | \$ 1,019,438 |
| Marketable equity securities, at market (cost: 2003 - \$15,118; 2002 - \$15,815) | 15,120 |
| Short-term investments, at cost, which approximates market | 396,977 |
| Other investments, at estimated fair value (cost: 2003 - \$2,170; 2002 - \$3,264) | 2,170 |
| Total investments | ----- 1,433,705 |
| Cash | 16,259 |
| Restricted cash | 224,909 |
| Premium, claims and other receivables | 923,473 |
| Reinsurance recoverables | 863,018 |
| Ceded unearned premium | 230,037 |
| Ceded life and annuity benefits | 78,575 |
| Deferred policy acquisition costs | 89,402 |
| Goodwill | 334,360 |
| Other assets | 162,428 |
| TOTAL ASSETS | ----- \$ 4,356,166 ===== |
| LIABILITIES | |
| Loss and loss adjustment expense payable | \$ 1,305,123 |
| Life and annuity policy benefits | 78,575 |

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| | |
|---|--------------|
| Reinsurance balances payable | 230,924 |
| Unearned premium | 497,770 |
| Deferred ceding commissions | 69,034 |
| Premium and claims payable | 825,159 |
| Notes payable | 311,639 |
| Accounts payable and accrued liabilities | 85,361 |
| | ----- |
| Total liabilities | 3,403,585 |
| SHAREHOLDERS' EQUITY | |
| Common stock, \$1.00 par value; 250.0 million shares authorized; (shares issued and outstanding: 2003 - 63,188; 2002 - 62,358) | 63,188 |
| Additional paid-in capital | 429,868 |
| Retained earnings | 431,911 |
| Accumulated other comprehensive income | 27,614 |
| | ----- |
| Total shareholders' equity | 952,581 |
| | ----- |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 4,356,166 |
| | ===== |

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Condensed Consolidated Statements of Earnings
(unaudited, in thousands, except per share data)

| | For the six months ended June 30, 2003 ---- | 2002 ---- | For |
|----------------------------------|---|--------------|-----|
| | (restated) | | (r |
| REVENUE | | | |
| Net earned premium | \$ 345,914 | \$ 226,105 | \$ |
| Fee and commission income | 74,226 | 69,764 | |
| Net investment income | 22,871 | 17,984 | |
| Net realized investment gain | 184 | 1,169 | |
| Other operating income | 5,116 | 2,140 | |
| | ----- | ----- | --- |
| Total revenue | 448,311 | 317,162 | |
| EXPENSE | | | |
| Loss and loss adjustment expense | 220,112 | 136,083 | |
| Operating expense: | | | |
| Policy acquisition costs, net | 65,869 | 42,288 | |
| Compensation expense | 42,861 | 33,515 | |

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| | | |
|--------------------------------------|-----------|-----------|
| Other operating expense | 27,196 | 22,805 |
| | ----- | ----- |
| Total operating expense | 135,926 | 98,608 |
| Interest expense | 3,596 | 4,841 |
| | ----- | ----- |
| Total expense | 359,634 | 239,532 |
| | ----- | ----- |
| Earnings before income tax provision | 88,677 | 77,630 |
| Income tax provision | 31,942 | 27,566 |
| | ----- | ----- |
| Net earnings | \$ 56,735 | \$ 50,064 |
| | ===== | ===== |
| BASIC EARNINGS PER SHARE DATA: | | |
| Earnings per share | \$ 0.90 | \$ 0.81 |
| | ===== | ===== |
| Weighted average shares outstanding | 62,753 | 62,087 |
| | ===== | ===== |
| DILUTED EARNINGS PER SHARE DATA: | | |
| Earnings per share | \$ 0.89 | \$ 0.80 |
| | ===== | ===== |
| Weighted average shares outstanding | 63,667 | 62,805 |
| | ===== | ===== |
| Cash dividends declared, per share | \$ 0.13 | \$ 0.125 |
| | ===== | ===== |

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Condensed Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2003 (restated)
(unaudited, in thousands, except per share data)

| | Common Stock | Additional paid-in Capital | Retained earnings | Accumulated other comprehensive income | T shar e |
|---------------------------------|-----------------|----------------------------------|----------------------|---|----------------|
| | ----- | ----- | ----- | ----- | ----- |
| BALANCE AS OF DECEMBER 31, 2002 | \$ 62,358 | \$ 416,406 | \$ 383,378 | \$ 20,765 | \$ |
| Net earnings | -- | -- | 56,735 | -- | |

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| | | | | |
|---|-----------|------------|------------|-----------|
| Other comprehensive income | -- | -- | -- | 6,849 |
| Comprehensive income | | | | |
| 778 shares of common stock issued for exercise of options, including tax benefit of \$2,323 | 778 | 13,514 | -- | -- |
| Issuance of 52 shares of contractually issuable common stock | 52 | (52) | -- | -- |
| Cash dividends declared, \$0.13 per share | -- | -- | (8,202) | -- |
| BALANCE AS OF JUNE 30, 2003 | \$ 63,188 | \$ 429,868 | \$ 431,911 | \$ 27,614 |

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(unaudited, in thousands, except per share data)

| | For the six months ended June 30, | |
|---|--------------------------------------|-----------|
| | 2003 | 2002 |
| | ---- | ---- |
| | (restated) | |
| Cash flows from operating activities: | | |
| Net earnings | \$ 56,735 | \$ 50,064 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Change in premium, claims and other receivables | (169,946) | (37,451) |
| Change in reinsurance recoverables | (64,084) | 30,036 |
| Change in ceded unearned premium | (65,813) | (39,310) |
| Change in loss and loss adjustment expense payable | 149,833 | (35,164) |
| Change in reinsurance balances payable | 64,265 | 38,459 |
| Change in unearned premium | 166,720 | 68,379 |
| Change in premium and claims payable, net of restricted cash | 58,845 | (41,378) |
| Depreciation and amortization expense | 5,564 | 5,378 |
| Other, net | (2,847) | 7,669 |
| Cash provided by operating activities | 199,272 | 46,682 |
| Cash flows from investing activities: | | |
| Sales of fixed income securities | 123,181 | 154,164 |
| Maturity or call of fixed income securities | 69,086 | 19,691 |
| Sales of equity securities | 1,165 | 3,417 |

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| | | |
|---|-----------|-----------|
| Other proceeds | 16,846 | -- |
| Change in short-term investments | (89,563) | 41,502 |
| Cost of securities acquired | (407,875) | (287,100) |
| Earnout payments for purchase of subsidiaries | (4,079) | -- |
| Purchases of property and equipment | (3,135) | (2,838) |
| | ----- | ----- |
| Cash used by investing activities | (294,374) | (71,164) |
| Cash flows from financing activities: | | |
| Proceeds from notes payable, net of costs | 134,845 | 40,000 |
| Sale of common stock, net of costs | 11,969 | 9,261 |
| Payments on notes payable | (67,622) | (13,269) |
| Dividends paid and other, net | (8,137) | (8,944) |
| | ----- | ----- |
| Cash provided by financing activities | 71,055 | 27,048 |
| | ----- | ----- |
| Net change in cash | (24,047) | 2,566 |
| Cash at beginning of period | 40,306 | 16,891 |
| | ----- | ----- |
| CASH AT END OF PERIOD | \$ 16,259 | \$ 19,457 |
| | ===== | ===== |

See Notes to Condensed Consolidated Financial Statements

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data)

(1) GENERAL INFORMATION

HCC Insurance Holdings, Inc. and its subsidiaries ("we," "us" and "our") provide specialized property and casualty and accident and health insurance coverages, underwriting agency and intermediary services to commercial customers and individuals. Our lines of business include group life, accident and health; aviation; our London market account (which includes energy, marine, property and some accident and health); diversified financial products (which includes directors and officers liability, errors and omissions, employment practices liability and surety); and other specialty lines of insurance. We operate primarily in the United States, the United Kingdom and Spain, although some of our operations have a broader international scope. We market our products both directly to customers and through a network of independent and affiliated agents and brokers.

Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include all adjustments which are, in our opinion, necessary for a fair presentation of the results of the interim periods. All adjustments made to the interim periods are of a normal recurring nature. The condensed consolidated financial statements include the accounts of HCC Insurance Holdings, Inc. and

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those of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated. The condensed consolidated financial statements for periods reported should be read in conjunction with the annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet as of December 31, 2002, was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

This Form 10-Q/A has amended our previously filed Form 10-Q to reflect a restatement to change the basis upon which the fee and commission income of our underwriting agency and intermediary subsidiaries are accounted. This restatement relates only to business underwritten by our underwriting agencies or placed by our intermediaries that passes through one of our affiliated insurance companies to an unrelated reinsurance company. This income had previously been recognized at the later of the effective date of a policy, the date when the premium could be reasonably established or the date when substantially all the services relating to the insurance placement had been rendered to the client. This income is now recognized pro rata over the term of the underlying policy. The cumulative effect of the restatement related to prior years, \$3.9 million, which is recorded in the first quarter of 2003, is not material to prior years or 2003. The effect of the change only became material in 2003 as a result of recent acquisitions. The change is a timing difference which generally reverses over a twelve month period. The restatement does not impact the overall amount of fees and commissions ultimately earned or previously collected in cash. Additionally, it does not change the net earnings of our reporting segments but, rather, results solely from changes to the consolidating entries made in the preparation of our condensed consolidated financial statements. Likewise, it does not change cash flow from operations.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(1) GENERAL INFORMATION, CONTINUED

The effect of the restatement on revenue was a reduction of \$13.8 million for the first six months of 2003 (\$2.9 million for the three months ended June 30, 2003). This amount includes \$6.5 million associated with the cumulative effect of the restatement related to prior years. The tables below show the effect on net earnings and earnings per share.

| | Amount | Earnings per share | |
|---|-----------|--------------------|---------|
| | ----- | Basic | Diluted |
| | | ----- | ----- |
| For the six months ended June 30, 2003: | | | |
| Net earnings, as previously reported | \$ 64,937 | \$ 1.03 | \$ 1.02 |
| Effect of adjustment on operations for the period | (4,312) | (0.07) | (0.07) |
| Cumulative adjustment | (3,890) | (0.06) | (0.06) |
| | ----- | ----- | ----- |

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| | | | |
|---|--------------------|------------------|------------------|
| Net earnings, as reported herein | \$ 56,735 ===== | \$ 0.90 ===== | \$ 0.89 ===== |
| For the three months ended June 30, 2003: | | | |
| Net earnings, as previously reported | \$ 34,662 | \$ 0.55 | \$ 0.54 |
| Effect of adjustment on operations for the period | (1,694) ----- | (0.03) ----- | (0.02) ----- |
| Net earnings, as reported herein | \$ 32,968 ===== | \$ 0.52 ===== | \$ 0.52 ===== |

During the fourth quarter of 2002, we completed three acquisitions. The results of operations of these entities are included in our consolidated financial statements beginning on the effective date of each transaction. Thus, our condensed consolidated statements of earnings and cash flows for the six and three months ended June 30, 2002 do not contain any activity generated by these three entities. We are still in the process of completing the purchase price allocation for two of these acquisitions as we are still gathering some of the information needed to make the required calculations. Any subsequent net adjustment will result in a change to recorded goodwill.

During the first quarter of 2003, we adopted prospectively Financial Accounting Standards Board Interpretation ("FIN") No. 46 entitled "Consolidation of Variable Interest Entities". We now consolidate an investment in a partnership that owns an office building leased to unaffiliated third parties, whereas previously we used the equity method of accounting to account for this investment. The partnership is not material to our financial position, results of operations or cash flows.

Fee and Commission Income

Our fee and commission income in our condensed consolidated statements of earnings includes fee income from our underwriting agencies and commission income from our intermediaries earned by underwriting on behalf of and/or placing business with unaffiliated (re)insurers and proceeds from ceded reinsurance (ceding commissions in excess of policy acquisition costs).

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(1) GENERAL INFORMATION, CONTINUED

Income Tax

For the six months and three months ended June 30, 2003 and 2002, the income tax provision has been calculated based on an estimated effective tax rate for each of the fiscal years. The difference between our effective tax rate and the Federal statutory rate is primarily the result of state income taxes and tax exempt municipal bond interest.

Stock Options

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We account for stock options granted to employees using the intrinsic value method of APB Opinion No. 25 entitled "Accounting for Stock Issued to Employees". All options have been granted at fixed exercise prices at the market price of our common stock at the grant date. Because of that, no stock-based employee compensation cost is reflected in our reported net income. Options vest over a period of up to seven years and expire four to ten years after grant date. The following table illustrates the effects on net earnings and earnings per share if we had used the fair value method of SFAS No. 123 entitled "Accounting for Stock-Based Compensation".

| | For the six months ended June 30, | | For the three months ended June 30, | |
|--|--------------------------------------|-----------|--|---------|
| | 2003 | 2002 | 2003 | 2002 |
| | ----- | ----- | ----- | ----- |
| Reported net earnings | \$ 56,735 | \$ 50,064 | \$ 32,968 | \$ 26,7 |
| Stock-based compensation using fair value method, net of income tax | (3,871) | (2,283) | (1,932) | (1,1 |
| | ----- | ----- | ----- | ----- |
| Pro forma net earnings | \$ 52,864 | \$ 47,781 | \$ 31,036 | \$ 25,5 |
| | ===== | ===== | ===== | ===== |
| Reported basic earnings per share | \$ 0.90 | \$ 0.81 | \$ 0.52 | \$ 0. |
| Fair value stock-based compensation | (0.06) | (0.04) | (0.03) | (0. |
| | ----- | ----- | ----- | ----- |
| Pro forma basic earnings per share | \$ 0.84 | \$ 0.77 | \$ 0.49 | \$ 0. |
| | ===== | ===== | ===== | ===== |
| Reported diluted earnings per share | \$ 0.89 | \$ 0.80 | \$ 0.52 | \$ 0. |
| Fair value stock-based compensation | (0.06) | (0.04) | (0.03) | (0. |
| | ----- | ----- | ----- | ----- |
| Pro forma diluted earnings per share | \$ 0.83 | \$ 0.76 | \$ 0.49 | \$ 0. |
| | ===== | ===== | ===== | ===== |

Reclassifications

Certain amounts in our 2002 condensed consolidated financial statements have been reclassified to conform to the 2003 presentation. Among these reclassifications, proceeds from ceded reinsurance (ceding commissions in excess of acquisition costs) have been classified as fee and commission income rather than a reduction of operating expenses. Also, compensation and other operating expenses of our underwriting agency subsidiaries representing acquisition costs have been classified as policy acquisition costs to be offset by the portion of ceding commissions which represent the reimbursement of those acquisition costs. Such reclassifications had no effect on our net earnings, shareholders' equity or cash flows.

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

(2) REINSURANCE

In the normal course of business our insurance companies cede a portion of their premium to non-affiliated domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although the ceding of reinsurance does not discharge the primary insurer from liability to its policyholder, our insurance companies participate in such agreements for the purpose of limiting their loss exposure, protecting them against catastrophic loss and diversifying their business. The following table represents the effect of such reinsurance transactions on premium and loss and loss adjustment expense:

| | Written Premium ----- | Earned Premium ----- |
|---|-----------------------------|----------------------------|
| For the six months ended June 30, 2003: | | |
| Direct business | \$ 654,610 | \$ 538,255 |
| Reinsurance assumed | 202,117 | 153,833 |
| Reinsurance ceded | (413,135) | (346,174) |
| | ----- | ----- |
| NET AMOUNTS | \$ 443,592 ===== | \$ 345,914 ===== |
| For the six months ended June 30, 2002: | | |
| Direct business | \$ 436,780 | \$ 378,086 |
| Reinsurance assumed | 116,840 | 104,996 |
| Reinsurance ceded | (295,958) | (256,977) |
| | ----- | ----- |
| NET AMOUNTS | \$ 257,662 ===== | \$ 226,105 ===== |
| For the three months ended June 30, 2003: | | |
| Direct business | \$ 357,830 | \$ 282,384 |
| Reinsurance assumed | 119,449 | 91,885 |
| Reinsurance ceded | (226,188) | (190,777) |
| | ----- | ----- |
| NET AMOUNTS | \$ 251,091 ===== | \$ 183,492 ===== |
| For the three months ended June 30, 2002: | | |
| Direct business | \$ 244,690 | \$ 193,527 |
| Reinsurance assumed | 61,162 | 55,468 |
| Reinsurance ceded | (170,462) | (134,368) |
| | ----- | ----- |
| NET AMOUNTS | \$ 135,390 ===== | \$ 114,627 ===== |

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(2) REINSURANCE, CONTINUED

The table below represents the composition of reinsurance recoverables in our condensed consolidated balance sheets:

| | June 30, 2003 | December 31, 2003 |
|---|---------------|-------------------|
| | ----- | ----- |
| Reinsurance recoverable on paid losses | \$ 109,506 | \$ 108,506 |
| Reinsurance recoverable on outstanding losses | 440,459 | 437,459 |
| Reinsurance recoverable on incurred but not reported losses | 322,649 | 260,649 |
| Reserve for uncollectible reinsurance | (9,596) | (7,596) |
| | ----- | ----- |
| TOTAL REINSURANCE RECOVERABLES | \$ 863,018 | \$ 798,018 |
| | ===== | ===== |

Our insurance companies require their reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize the reinsurance obligations due to us. The table below shows amounts held by us as collateral plus other credits available for potential offset.

| | June 30, 2003 | December 31, 2003 |
|------------------------|---------------|-------------------|
| | ----- | ----- |
| Payables to reinsurers | \$ 334,190 | \$ 235,190 |
| Letters of credit | 150,314 | 141,314 |
| Cash deposits | 9,102 | 9,102 |
| | ----- | ----- |
| TOTAL CREDITS | \$ 493,606 | \$ 386,606 |
| | ===== | ===== |

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

| | June 30, 2003 | December 31, 2003 |
|---|---------------|-------------------|
| | ----- | ----- |
| Loss and loss adjustment expense payable | \$1,305,123 | \$ 1,155,123 |
| Reinsurance recoverable on outstanding losses | (440,459) | (437,459) |
| Reinsurance recoverable on incurred but not reported losses | (322,649) | (260,649) |

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| | | |
|---------------------------------------|---------------------|------------------|
| NET RESERVES | \$ 542,015 ===== | \$ 457, ===== |
| Unearned premium | \$ 497,770 | \$ 331, |
| Ceded unearned premium | (230,037) ----- | (164, ----- |
| NET UNEARNED PREMIUM | \$ 267,733 ===== | \$ 166, ===== |
| Deferred policy acquisition costs | \$ 89,402 | \$ 68, |
| Deferred ceding commissions | (69,034) ----- | (49, ----- |
| NET DEFERRED POLICY ACQUISITION COSTS | \$ 20,368 ===== | \$ 18, ===== |

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(2) REINSURANCE, CONTINUED

We have a reserve of \$9.6 million as of June 30, 2003 for potential collectibility issues and associated expenses related to reinsurance recoverables. The adverse economic environment in the worldwide insurance industry, the decline in the market value of investments in equity securities and the terrorist attack on September 11, 2001 have placed great pressure on certain reinsurers and the results of their operations. Ultimately, these conditions could affect reinsurers' solvency. Historically, there have been insolvencies following a period of competitive pricing in the industry. We limit our exposure by holding funds, letters of credit or other security such that net balances due are significantly less than the gross balances shown in our condensed consolidated balance sheets. While we believe that the reserve is adequate based on currently available information, conditions may change or additional information might be obtained which may result in a future change in the reserve. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

A number of reinsurers have delayed or suspended the payment of amounts recoverable under certain reinsurance contracts to which we are a party. Such delays have affected, although not materially to date, the investment income of our insurance companies, but not to any extent their liquidity. In some instances, the reinsurers have withheld payment without reference to a substantive basis for the delay or suspension. In other cases, the reinsurers have claimed they are not liable for payment to us of all or part of the amounts due under the applicable reinsurance agreement. We believe these claims are substantially without merit and expect to collect the full amounts recoverable. We are currently in negotiations with most of these

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parties, but if such negotiations do not result in a satisfactory resolution of the matters in question, we may seek or be involved in a judicial or arbitral determination of these matters. In some cases, the final resolution of such disputes through arbitration or litigation may extend over several years. In this regard, as of June 30, 2003, our insurance companies had initiated two litigation proceedings against reinsurers. As of such date, our insurance companies had an aggregate amount of \$5.7 million which had not been paid to us under the agreements and we estimate that there could be up to an additional \$8.7 million of incurred losses and loss expenses and other balances which could become due under the subject agreements.

(3) SEGMENT AND GEOGRAPHIC INFORMATION

The performance of each segment is evaluated based upon net earnings and is calculated after tax and after all corporate expense allocations, purchase price allocations and intercompany eliminations have been charged or credited to the individual segments. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated. During the second quarter of 2003 we reclassified one of our subsidiaries, which was acquired in December 2002, from the underwriting agency segment to the intermediary segment in order to better match our segment presentation with the way we make decisions and assess performance. This reclassification has been made in all 2003 tables presented. The revenues within our underwriting agency and intermediary segments for 2002, have been reclassified to be consistent with the 2003 presentation. This reclassification did not change segment total revenue or segment net earnings from amounts previously reported. Certain reinsurance proceeds of our insurance subsidiaries have also been reclassified to revenue to be consistent with the classification in the condensed consolidated financial statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

| | Insurance Company ----- | Underwriting Agency ----- | Intermediary ----- | Op ----- |
|---|-------------------------------|---------------------------------|-----------------------|-------------|
| For the six months ended June 30, 2003: | | | | |
| Revenue: | | | | |
| Domestic | \$284,796 | \$ 27,815 | \$ 11,530 | \$ |
| Foreign | 101,273 | 1,275 | 16,182 | |
| Inter-segment | -- | 45,198 | 2,901 | |
| | | | | |
| TOTAL SEGMENT REVENUE | \$386,069 | \$ 74,288 | \$ 30,613 | \$ |
| | | | | |

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Inter-segment revenue

CONSOLIDATED TOTAL REVENUE

| | | | | |
|----------------------------|-----------|-----------|----------|----|
| Net earnings: | | | | |
| Domestic | \$ 31,960 | \$ 19,090 | \$ 3,017 | \$ |
| Foreign | 7,201 | 1,901 | 3,039 | |
| | ----- | | | |
| TOTAL SEGMENT NET EARNINGS | \$ 39,161 | \$ 20,991 | \$ 6,056 | \$ |
| | ===== | | | |

Inter-segment eliminations

CONSOLIDATED NET EARNINGS

| | | | | |
|-------------------------------|-----------|----------|--------|----|
| Other items: | | | | |
| Net investment income | \$ 20,227 | \$ 1,242 | \$ 591 | \$ |
| Depreciation and amortization | 1,617 | 1,463 | 1,077 | |
| Interest expense (benefit) | 25 | 3,411 | 1,790 | |
| Capital expenditures | 1,231 | 668 | 888 | |
| Income tax provision | 19,201 | 13,130 | 3,660 | |
| Inter-segment eliminations | | | | |

CONSOLIDATED INCOME TAX PROVISION

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

| | Insurance Company | Underwriting Agency | Intermediary | Op |
|---|----------------------|------------------------|--------------|-------|
| | ----- | ----- | ----- | ----- |
| For the six months ended June 30, 2002: | | | | |
| Revenue: | | | | |
| Domestic | \$224,058 | \$ 35,529 | \$ 12,452 | \$ |
| Foreign | 33,948 | 591 | 9,189 | |
| Inter-segment | -- | 17,266 | 405 | |
| | ----- | | | |
| TOTAL SEGMENT REVENUE | \$258,006 | \$ 53,386 | \$ 22,046 | \$ |
| | ===== | | | |

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Inter-segment revenue

CONSOLIDATED TOTAL REVENUE

| | | | | |
|----------------------------|-----------|-----------|----------|----|
| Net earnings: | | | | |
| Domestic | \$ 30,239 | \$ 11,399 | \$ 2,884 | \$ |
| Foreign | 2,740 | 257 | 1,268 | |
| | | | | |
| TOTAL SEGMENT NET EARNINGS | \$ 32,979 | \$ 11,656 | \$ 4,152 | \$ |
| | | | | |

Inter-segment eliminations

CONSOLIDATED NET EARNINGS

| | | | | |
|-------------------------------|-----------|----------|--------|----|
| Other items: | | | | |
| Net investment income | \$ 15,974 | \$ 1,330 | \$ 464 | \$ |
| Depreciation and amortization | 1,518 | 3,111 | 170 | |
| Interest expense (benefit) | 73 | 3,880 | 1,288 | |
| Capital expenditures | 1,007 | 800 | 695 | |
| Income tax provision | 16,014 | 7,305 | 3,581 | |
| Inter-segment eliminations | | | | |

CONSOLIDATED INCOME TAX PROVISION

14

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

| | Insurance Company | Underwriting Agency | Intermediary | Op |
|---|----------------------|------------------------|--------------|----|
| For the three months ended June 30, 2003: | | | | |
| Revenue: | | | | |
| Domestic | \$147,560 | \$ 17,297 | \$ 6,559 | \$ |
| Foreign | 56,951 | 2,374 | 8,185 | |
| Inter-segment | -- | 20,301 | 753 | |
| | | | | |
| TOTAL SEGMENT REVENUE | \$204,511 | \$ 39,972 | \$15,497 | \$ |
| | | | | |

Inter-segment revenue

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CONSOLIDATED TOTAL REVENUE

| | | | | |
|----------------------------|-----------|-----------|----------|----|
| Net earnings: | | | | |
| Domestic | \$ 15,987 | \$ 10,345 | \$ 1,475 | \$ |
| Foreign | 3,814 | 1,415 | 1,197 | |
| | ----- | | | |
| TOTAL SEGMENT NET EARNINGS | \$ 19,801 | \$ 11,760 | \$ 2,672 | \$ |
| | ===== | | | |

Inter-segment eliminations

CONSOLIDATED NET EARNINGS

| | | | | |
|-------------------------------|-----------|--------|--------|----|
| Other items: | | | | |
| Net investment income | \$ 10,197 | \$ 581 | \$ 319 | \$ |
| Depreciation and amortization | 796 | 87 | 776 | |
| Interest expense (benefit) | 16 | 1,599 | 1,152 | |
| Capital expenditures | 791 | 151 | 587 | |
| Income tax provision | 10,440 | 7,570 | 1,365 | |
| Inter-segment eliminations | | | | |

CONSOLIDATED INCOME TAX PROVISION

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

| | Insurance Company | Underwriting Agency | Intermediary | Op |
|---|----------------------|------------------------|--------------|-------|
| | ----- | ----- | ----- | ----- |
| For the three months ended June 30, 2002: | | | | |
| Revenue: | | | | |
| Domestic | \$113,961 | \$18,131 | \$ 7,314 | \$ |
| Foreign | 17,153 | 84 | 3,946 | |
| Inter-segment | -- | 8,823 | 148 | |
| | ----- | | | |
| TOTAL SEGMENT REVENUE | \$131,114 | \$27,038 | \$11,408 | \$ |
| | ===== | | | |

Inter-segment revenue

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| CONSOLIDATED TOTAL REVENUE | | | | |
|-----------------------------------|-----------|----------|----------|----|
| Net earnings (loss): | | | | |
| Domestic | \$ 15,875 | \$ 6,164 | \$ 2,319 | \$ |
| Foreign | 2,204 | (1) | 124 | |
| ----- | | | | |
| TOTAL SEGMENT NET EARNINGS (LOSS) | \$ 18,079 | \$ 6,163 | \$ 2,443 | \$ |
| ===== | | | | |
| Inter-segment eliminations | | | | |
| | | | | |
| CONSOLIDATED NET EARNINGS | | | | |
| Other items: | | | | |
| Net investment income | \$ 8,282 | \$ 615 | \$ 242 | \$ |
| Depreciation and amortization | 760 | 1,504 | 84 | |
| Interest expense (benefit) | -- | 1,894 | 644 | |
| Capital expenditures | 505 | 376 | 405 | |
| Income tax provision | 8,695 | 4,168 | 1,880 | |
| Inter-segment eliminations | | | | |

CONSOLIDATED INCOME TAX PROVISION

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

The following tables present selected revenue items by line of business for the periods indicated:

| | For the six months ended June 30, | | For the three m |
|-----------------------------------|-----------------------------------|------------|-----------------|
| | 2003 | 2002 | 2003 |
| | ---- | ---- | ---- |
| Group life, accident and health | \$ 147,509 | \$ 105,805 | \$ 75,526 |
| Diversified financial products | 44,818 | 7,277 | 26,512 |
| London market account | 66,457 | 32,521 | 37,081 |
| Aviation | 48,237 | 50,754 | 24,355 |
| Other specialty lines of business | 19,081 | 8,982 | 9,553 |
| | ----- | ----- | ----- |
| | 326,102 | 205,339 | 173,027 |
| Discontinued lines of business | 19,812 | 20,766 | 10,465 |
| | ----- | ----- | ----- |

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| | | | |
|---------------------------------|------------|------------|------------|
| NET EARNED PREMIUM | \$ 345,914 | \$ 226,105 | \$ 183,492 |
| | ===== | ===== | ===== |
| Group life, accident and health | \$ 41,474 | \$ 47,512 | \$ 21,529 |
| Property and casualty | 32,752 | 22,252 | 22,579 |
| | ----- | ----- | ----- |
| FEE AND COMMISSION INCOME | \$ 74,226 | \$ 69,764 | \$ 44,108 |
| | ===== | ===== | ===== |

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(4) EARNINGS PER SHARE

Basic earnings per share is based on the weighted average number of common shares outstanding during the period divided into net earnings. Diluted earnings per share is based on the weighted average number of common shares outstanding plus the potential common shares outstanding during the period divided into net earnings. Outstanding common stock options, when dilutive, are considered to be potential common shares for the purpose of the diluted calculation. The treasury stock method is used to calculate potential common shares due to options. Contingent shares to be issued are included in the earnings per share computation when the underlying conditions for issuance have been met.

The following table provides a reconciliation of the denominators used in the earnings per share calculations:

| | For the six months ended June 30, 2003 | 2002 | For the three m 2003 |
|--|---|-----------|-------------------------|
| | ---- | ---- | ---- |
| Net earnings | \$ 56,735 | \$ 50,064 | \$ 32,968 |
| | ===== | ===== | ===== |
| Reconciliation of shares outstanding: | | | |
| Shares of common stock outstanding at period end | 63,188 | 62,232 | 63,188 |
| Effect of common shares issued during the period | (435) | (197) | (321) |
| Common shares contractually issuable in the future | -- | 52 | -- |
| | ----- | ----- | ----- |
| Weighted average common shares outstanding | 62,753 | 62,087 | 62,867 |
| Additional dilutive effect of outstanding options (as determined by the application of the treasury stock method) | 914 | 718 | 1,123 |

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| | | | |
|--|--------|--------|--------|
| | ----- | ----- | ----- |
| Weighted average shares and potential common shares outstanding | 63,667 | 62,805 | 63,990 |
| | ===== | ===== | ===== |
| Anti-dilutive shares not included in computation | 499 | 364 | 174 |
| | ===== | ===== | ===== |

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(5) NOTES PAYABLE

The table below shows the composition of our notes payable as shown in our condensed consolidated balance sheets.

| | June 30, 2003 | December 31, 2002 |
|---------------------------------------|---------------|-------------------|
| | ----- | ----- |
| 1.3% Convertible notes | \$ 125,000 | \$ -- |
| 2% Convertible notes | 172,451 | 172,451 |
| \$200 million revolving loan facility | -- | 53,000 |
| Other debt | 14,188 | 4,576 |
| | ----- | ----- |
| TOTAL NOTES PAYABLE | \$ 311,639 | \$ 230,027 |
| | ===== | ===== |

In a public offering on March 25, 2003, we sold an aggregate \$125.0 million principal amount of 1.3% convertible notes due in 2023. Each one thousand principal amount of notes is convertible into 29.4377 shares of our common stock, which represents an initial conversion price of \$33.97 per share. The initial conversion price is subject to change under certain conditions. Interest is to be paid by us on April 1 and October 1 each year, commencing October 1, 2003. Holders may surrender notes for conversion into shares of our common stock if, as of the last day of the preceding calendar quarter, the closing sale price of our common stock for at least 20 consecutive trading days during the period of 30 consecutive trading days ending on the last trading day of that quarter is more than 130% (\$44.16 per share) of the conversion price per share of our common stock. We can redeem the notes for cash at any time on or after April 4, 2009. Holders of the notes may require us to repurchase the notes on April 1, 2009, 2014 and 2019 at a price equal to the principal amount of the notes plus accrued and unpaid interest. If the holders require us to repurchase these notes, we may choose to pay the purchase price in cash, in shares of our common stock, or in a combination thereof. We paid \$3.2 million in underwriting discounts and expenses in connection with this offering, which is being amortized from the issue date until April 1, 2009. We used \$66.0 million of the proceeds from this offering to pay down existing indebtedness under our bank facility, while the remainder is

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available to assist in financing future acquisitions and strategic investments and for general corporate purposes.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(6) SUPPLEMENTAL INFORMATION

| | For the six months ended June 30, | | For the three months |
|--|-----------------------------------|----------|----------------------|
| | 2003 | 2002 | 2003 |
| | ---- | ---- | ---- |
| Interest paid | \$ 2,721 | \$ 2,417 | \$ 290 |
| Income tax paid | 32,102 | 13,020 | 26,171 |
| Comprehensive income | 63,584 | 55,132 | 40,640 |
| Ceding commissions netted with policy acquisition costs | 54,313 | 38,398 | 29,934 |

(7) COMMITMENTS AND CONTINGENCIES

In addition to the matters discussed in Note (2) Reinsurance, we are party to numerous lawsuits and other proceedings that arise in the normal course of our business. Many of such lawsuits and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits and other proceedings which relate to disputes over contractual relationships with third parties, or which involve alleged errors and omissions on the part of our subsidiaries. In addition, we are presently engaged in litigation initiated by the appointed liquidator of a former reinsurer concerning payments made to us prior to the date of the appointment of the liquidator. The disputed payments were made by the now insolvent reinsurer in connection with a commutation agreement. Our understanding is that such litigation is one of a number of similar actions brought by the liquidator. We intend to vigorously contest the action. We do not believe the resolution of any of these matters, some of which include allegations of damages of material amounts, will have a material adverse effect on our financial condition, results of operations or cash flows.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS

This Form 10-Q/A has amended our previously filed Form 10-Q to reflect a restatement to change the basis upon which the fee and commission income of our underwriting agency and intermediary subsidiaries are accounted. This restatement relates only to business underwritten by our underwriting agencies or placed by our intermediaries that passes through one of our affiliated insurance companies to an unrelated reinsurance company. This income had previously been recognized at the later of the effective date of a policy, the

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date when the premium could be reasonably established or the date when substantially all the services relating to the insurance placement had been rendered to the client. This income is now recognized pro rata over the term of the underlying policy. The cumulative effect of the restatement related to prior years, \$3.9 million, which is recorded in the first quarter of 2003, is not material to prior years or 2003. The effect of the change only became material in 2003 as a result of recent acquisitions. The change is a timing difference which generally reverses over a twelve month period. The restatement does not impact the overall amount of fees and commissions ultimately earned or previously collected in cash. Additionally, it does not change the net earnings of our reporting segments but, rather, results solely from changes to the consolidating entries made in the preparation of our condensed consolidated financial statements. Likewise, it does not change cash flow from operations.

The effect of the restatement on revenue was a reduction of \$13.8 million for the first six months of 2003 (\$2.9 million for the three months ended June 30, 2003). This amount includes \$6.5 million associated with the cumulative effect of the restatement related to prior years. The tables below show the effect on net earnings and earnings per share.

| | Amount ----- | Earnings per share | |
|---|--------------------|--------------------|------------------|
| | | Basic ----- | Dilut ----- |
| For the six months ended June 30, 2003: | | | |
| Net earnings, as previously reported | \$ 64,937 | \$ 1.03 | \$ 1.00 |
| Effect of adjustment on operations for the period | (4,312) | (0.07) | (0.00) |
| Cumulative adjustment | (3,890) | (0.06) | (0.00) |
| | ----- | ----- | ----- |
| Net earnings, as reported herein | \$ 56,735 ===== | \$ 0.90 ===== | \$ 0.80 ===== |
| For the three months ended June 30, 2003: | | | |
| Net earnings, as previously reported | \$ 34,662 | \$ 0.55 | \$ 0.50 |
| Effect of adjustment on operations for the period | (1,694) | (0.03) | (0.00) |
| | ----- | ----- | ----- |
| Net earnings, as reported herein | \$ 32,968 ===== | \$ 0.52 ===== | \$ 0.50 ===== |

Results of Operations

Six months ended June 30, 2003 versus six months ended June 30, 2002

Total revenue increased 41% to \$448.3 million for the first six months of 2003 from \$317.2 million for the same period in 2002. The revenue increase resulted from premium rate increases, increased business in all segments and subsidiaries acquired during 2002.

Net investment income increased 27% to \$22.9 million for the first six months of 2003 from \$18.0 million for the same period in 2002. This increase was due to the higher level of invested assets resulting primarily from cash flow generated by operating activities and from the insurance company we acquired in December, 2002. Cash flow from operating activities was \$199.3 million for the first six months of 2003 compared to \$46.7 million for the same period in 2002, continuing a trend of increasing operating cash flow that began in 2002. The majority

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of the increase in cash flow from operations results from increased earnings and net premium flow into our insurance companies. We expect the positive cash flow provided by operating activities to continue, most of which will increase invested assets and thus the related investment income. If market interest rates were to rise, the growth in investment income would be accelerated as our current portfolio has a relatively short average duration and would be available to be invested on a longer term basis to take advantage of higher rates. For the first six months of 2003 our annualized, weighted average, tax equivalent yield was 4.3% compared to 4.2% for the same period in 2002.

Compensation expense increased to \$42.9 million during the first six months of 2003 from \$33.5 million for the same period in 2002. Most of this increase is due to subsidiaries acquired during 2002.

Other operating expense increased to \$27.2 million during the first six months of 2003 compared to \$22.8 million in 2002, again primarily due to subsidiaries acquired during 2002. Currency gains amounted to \$0.8 million during the first six months of 2003 compared to gains of \$0.4 million during the same period in 2002. In addition, in 2003 there was a one-time currency gain of \$1.3 million from the settlement of an advance of funds to an unaffiliated entity. During the first six months of 2003 our insurance company subsidiaries incurred unusually high special assessments from certain states and state agencies of \$5.4 million compared to \$1.0 million during the same period in 2002. Assessments of this magnitude are not expected in the future.

Interest expense was \$3.6 million for the first six months of 2003 compared to \$4.8 million for the same period in 2002. Included in the 2002 amount is \$2.2 million representing the amortization of underwriting discounts and expenses, which were fully amortized in 2002, related to the issuance of our 2% convertible notes compared to \$0.2 million in 2003 related to our 1.3% convertible notes, which were issued in March 2003. Partially offsetting the decrease in amortization is the interest on mortgage debt from a real estate partnership we are now consolidating with our adoption of Financial Accounting Standards Board Interpretation ("FIN") No. 46 during 2003 and the additional interest expense from our 1.3% convertible notes.

Income tax expense was \$31.9 million for the first six months of 2003 compared to \$27.6 million for the same period in 2002. Our effective tax rate was 36.0% in the 2003 period compared to 35.5% in 2002. The increased rate results from a reduction of the positive effect of tax exempt interest net of a reduction of the effect of state income taxes as our income before tax increases, especially in our insurance companies which are generally not subject to state income taxes, as well as immaterial adjustments made to refine our various tax accrual amounts.

Net earnings increased 13% to \$56.7 million, or \$0.89 per diluted share, for the first six months of 2003 from \$50.1 million, or \$0.80 per diluted share, for the same period in 2002. The increase in net earnings resulted from continuing good margins on increasing revenue and the effect of acquisitions consummated in 2002.

As of June 30, 2003, total assets exceeded \$4.3 billion, shareholders' equity was \$952.6 million and book value per share was \$15.08, up from \$14.15 as of December 31, 2002.

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Insurance Companies

The following tables provide information by line of business (amounts in thousands):

| | Gross written premium ----- | Net Written Premium ----- | Net Earned Premium ----- |
|---|--------------------------------------|------------------------------------|-----------------------------------|
| For the six months ended June 30, 2003: | | | |
| Group life, accident and health | \$ 283,482 | \$ 157,353 | \$ 147,509 |
| Diversified financial products | 250,426 | 82,214 | 44,818 |
| London market account | 140,152 | 102,554 | 66,457 |
| Aviation | 108,960 | 51,204 | 48,237 |
| Other specialty lines of business | 46,056 | 38,706 | 19,081 |
| | ----- | ----- | ----- |
| | 829,076 | 432,031 | 326,102 |
| Discontinued lines of business | 27,651 | 11,561 | 19,812 |
| | ----- | ----- | ----- |
| TOTALS | \$ 856,727 ===== | \$ 443,592 ===== | \$ 345,914 ===== |

Expense Ratio

Combined Ratio

For the six months ended June 30, 2002:

| | | | |
|-----------------------------------|---------------------|---------------------|---------------------|
| Group life, accident and health | \$ 245,659 | \$ 107,028 | \$ 105,805 |
| Diversified financial products | 58,369 | 15,133 | 7,277 |
| London market account | 116,053 | 61,939 | 32,521 |
| Aviation | 104,104 | 52,054 | 50,754 |
| Other specialty lines of business | 9,884 | 8,965 | 8,982 |
| | ----- | ----- | ----- |
| | 534,069 | 245,119 | 205,339 |
| Discontinued lines of business | 19,551 | 12,543 | 20,766 |
| | ----- | ----- | ----- |
| TOTALS | \$ 553,620 ===== | \$ 257,662 ===== | \$ 226,105 ===== |

Expense Ratio

Combined Ratio

Gross written premium increased 55% to \$856.7 million for the first six months of 2003 from \$553.6 million for the same period in 2002. All of the lines of business showed some increase as a result of increases in premium rates as well as organic growth, but the largest growth was in the diversified financial products line of business, which our insurance companies began writing in 2002. Net written premium for the first six months of 2003 increased 72% to \$443.6

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million and net earned premium increased 53% to \$345.9 million. The increase in premium is expected to continue throughout 2003 and into 2004.

Loss and loss adjustment expense was \$220.1 million for the first six months of 2003 compared to \$136.1 million for the same period in 2002. The net loss ratio was 63.6% for the first six months of 2003 compared to 60.2% for the same period in 2002. Prior year net reserve deficiency included in loss and loss adjustment expense approximated \$9.8 million for the first six months of 2003 compared to a redundancy of \$1.9 million for the same period in 2002. For the same periods, the gross loss ratio was 72.9% in 2003 compared to 60.1% in 2002. During the first six months of 2003, we increased our gross losses by \$76.1 million on certain assumed accident and health reinsurance contracts reported in the discontinued line of business due to our processing of additional information received and our continuing evaluation of reserves related to this business. This had the effect of

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increasing our aggregate gross loss ratio by 9.3%. During the first six months of 2002, we reduced our gross losses from the September 11 terrorist attacks by \$21.5 million, which had the effect of reducing our gross loss ratio by 4.5%. As these assumed reinsurance contracts and September 11 losses were substantially reinsured, there was no material effect on our net losses.

The net loss experience in the diversified financial products line of business increased in 2003 as a result of a change in the mix of business as the line expands rapidly and our conservative reserving philosophy on new business. The London market account's net loss ratio was negatively affected in 2003 due to an increase in reserves in the accident and health category, some of which was adverse development from prior accident years. The net loss ratio in the aviation line of business increased from the first six months of 2002, due in part to some unusually large losses. Loss experience in the other specialty lines improved in 2003 compared to the prior year as it approached its expected level. The loss ratio in the discontinued lines of business increased in the first six months of 2003 primarily due to prior year reserve development as we increased reserves towards the mid-point of the actuarial range.

Policy acquisition costs, which are net of commissions on reinsurance ceded, increased to \$65.9 million during the first six months of 2003, from \$42.3 million in the same period in 2002. This increase is in proportion to the increase in net earned premium.

Net earnings of our insurance companies increased to \$39.2 million in the first six months of 2003 from \$33.0 million for the same period in 2002 due to increased premium volume from rate increases, organic growth, a subsidiary acquired in 2002 and continuing profitable underwriting results somewhat offset by strengthening of prior period reserves and unusually high assessments from certain states and state agencies. We expect this growth to continue into 2004.

Underwriting Agencies

Revenue from our underwriting agencies (primarily fee income) increased 39% to \$74.3 million for the first six months of 2003 compared to \$53.4 million for the same period in 2002. This growth was both from acquisitions made during 2002 and from internal growth, partially offset by decreases from underwriting agencies consolidated into our insurance companies during prior years. Net earnings in this segment increased to \$21.0 million in the first six months of 2003 from \$11.7 million in 2002 for the same reasons. We expect this growth to continue into 2004.

Intermediaries

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Revenue from our intermediaries (primarily commission income) increased 39% to \$30.6 million for the first six months of 2003 compared to \$22.0 million for the same period in 2002 due to improved market conditions, growth in non-affiliated business and an acquisition made during 2002. Net earnings of our intermediaries increased to \$6.1 million for the first six months of 2003 compared to \$4.2 million for the same period of 2002 for the same reasons. We expect this growth to continue into 2004.

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Other Operations

The other operations segment saw an increase in revenue and segment net income due to income from our strategic investment in Argonaut Group, Inc. made in March 2003 and gains in our strategic investment and trading accounts, as well as the initial consolidation of a real estate partnership to comply with FIN No. 46. Period to period comparisons may vary substantially depending on strategic investments, trading activities or dispositions in any given period.

Corporate

The net earnings of the corporate segment were \$0.5 million for the first six months of 2003 compared to \$1.3 million for the same period in 2002. The decrease between periods resulted from the difference in intersegment income tax adjustments and the adjustment of certain accruals to their ultimate liability, which positively affected the 2002 period. There was also an increase in compensation expense during 2003, offsetting reduced net interest expense and currency conversion gains.

Quarter ended June 30, 2003 versus quarter ended June 30, 2002

Total revenue increased 51% to \$243.9 million for the second quarter of 2003 from \$161.1 million for the same period in 2002. The revenue increase resulted from premium rate increases, increased business in all segments and subsidiaries acquired during 2002.

Net investment income increased 28% to \$11.9 million for the second quarter of 2003 from \$9.3 million for the same period in 2002. This increase was due to the higher level of invested assets resulting primarily from cash flow generated by operating activities and from the insurance company we acquired in December, 2002. Cash flow from operating activities was \$97.4 million for the second quarter of 2003 compared to \$33.6 million for the same period in 2002, continuing a trend of increasing operating cash flow that began in 2002. The majority of the increase in cash flow from operations results from increased earnings and net premium flow into our insurance companies. We expect the positive cash flow provided by operating activities to continue, most of which will increase invested assets and thus the related investment income. If market interest rates were to rise, the growth in investment income would be accelerated as our current portfolio has a relatively short average duration and would be available to be invested on a longer term basis to take advantage of higher rates. For the second quarter of 2003 our annualized, weighted average, tax equivalent yield was 4.4% compared to 4.1% for the same period in 2002.

Compensation expense increased to \$22.4 million during the second quarter of 2003 from \$16.8 million for the same period in 2002. Most of this increase is due to subsidiaries acquired during 2002.

Other operating expense increased to \$13.5 million during the second quarter of 2003 compared to \$10.8 million in 2002, again primarily due to subsidiaries

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acquired during 2002. Currency gains amounted to \$0.8 million during the second quarter of 2003 compared to gains of \$0.6 million during the same period in 2002. In addition, in 2003 there was a one-time currency gain of \$1.3 million from the settlement of an advance of funds to an unaffiliated entity. During the second quarter of 2003 our insurance company subsidiaries incurred unusually high special assessments from certain states and state agencies of \$3.0 million compared to \$0.6 million during the same period in 2002. Assessments of this magnitude are not expected in the future.

Interest expense was \$1.9 million for the second quarter of 2003 compared to \$2.5 million for the same period in 2002. Included in the 2002 amount is \$1.1 million representing the amortization of underwriting discounts and expenses, which were fully amortized in 2002, related to the issuance of our 2% convertible notes compared to \$0.2 million in 2003 related to our 1.3% convertible notes, which were issued in March 2003. Partially offsetting the decrease in amortization is the interest on mortgage debt from a real estate partnership we are now consolidating with our adoption of FIN No. 46 during 2003 and the additional interest expense from our 1.3% convertible notes.

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Income tax expense was \$19.1 million for the second quarter of 2003 compared to \$15.1 million for the same period in 2002. Our effective tax rate was 36.7% in the 2003 quarter compared to 36.1% in 2002. The increased rate results from a reduction of the positive effect of tax exempt interest net of a reduction of the effect of state income taxes as our income before tax increases, especially in our insurance companies which are generally not subject to state income taxes, as well as immaterial adjustments made to refine our various tax accrual amounts.

Net earnings increased 23% to \$33.0 million, or \$0.52 per diluted share, for the second quarter of 2003 from \$26.8 million, or \$0.43 per diluted share, for the same period in 2002. The increase in net earnings resulted from continuing good margins on increasing revenue and the effect of acquisitions consummated in 2002.

As of June 30, 2003, total assets exceeded \$4.3 billion, shareholders' equity was \$952.6 million and book value per share was \$15.08, up from \$14.46 as of March 31, 2003.

SEGMENTS

Insurance Companies

The following tables provide information by line of business (amounts in thousands):

| | Gross written premium | Net Written Premium | Net Earned Premium | Net Loss Ratio |
|---|-----------------------------|---------------------------|--------------------------|----------------------|
| For the three months ended June 30, 2003: | | | | |
| Group life, accident and health | \$ 144,162 | \$ 81,168 | \$ 75,526 | 63.7% |
| Diversified financial products | 143,106 | 48,907 | 26,512 | 50.8 |
| London market account | 79,434 | 65,322 | 37,081 | 61.3 |
| Aviation | 64,429 | 30,525 | 24,355 | 61.9 |
| Other specialty lines of business | 25,176 | 21,256 | 9,553 | 81.2 |

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| | | | | |
|---|------------|------------|----------------|-------|
| | ----- | ----- | ----- | ----- |
| | 456,307 | 247,178 | 173,027 | 61.9 |
| Discontinued lines of business | 20,972 | 3,913 | 10,465 | 123.7 |
| | ----- | ----- | ----- | ----- |
| TOTALS | \$ 477,279 | \$ 251,091 | \$ 183,492 | 65.4% |
| | ===== | ===== | ===== | |
| | | | Expense Ratio | 23.7 |
| | | | | ----- |
| | | | Combined Ratio | 89.1% |
| | | | | ===== |
| For the three months ended June 30, 2002: | | | | |
| Group life, accident and health | \$ 122,755 | \$ 55,208 | \$ 54,238 | 63.2% |
| Diversified financial products | 42,556 | 7,792 | 4,574 | 26.8 |
| London market account | 68,508 | 33,403 | 16,269 | 46.6 |
| Aviation | 59,990 | 29,421 | 25,571 | 47.7 |
| Other specialty lines of business | 5,682 | 5,384 | 5,347 | 128.7 |
| | ----- | ----- | ----- | ----- |
| | 299,491 | 131,208 | 105,999 | 58.7 |
| Discontinued lines of business | 6,361 | 4,182 | 8,628 | 64.6 |
| | ----- | ----- | ----- | ----- |
| TOTALS | \$ 305,852 | \$ 135,390 | \$ 114,627 | 59.1% |
| | ===== | ===== | ===== | |
| | | | Expense Ratio | 25.3 |
| | | | | ----- |
| | | | Combined Ratio | 84.4% |
| | | | | ===== |

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Gross written premium increased 56% to \$477.3 million for the second quarter of 2003 from \$305.9 million for the same period in 2002. All of the lines of business showed some increase as a result of increases in premium rates as well as organic growth, but the largest growth was in the diversified financial products line of business, which our insurance companies began writing in 2002. Net written premium for the second quarter of 2003 increased 85% to \$251.1 million and net earned premium increased 60% to \$183.5 million. The increase in premium is expected to continue throughout 2003 and into 2004.

Loss and loss adjustment expense was \$120.1 million for the second quarter of 2003 compared to \$67.8 million for the same period in 2002. The net loss ratio was 65.4% for the second quarter of 2003 compared to 59.1% for the same period in 2002. Prior year net reserve deficiency included in loss and loss adjustment expense approximated \$8.5 million for the second quarter of 2003 compared to a redundancy of \$0.2 million for the same period in 2002. For the same periods, the gross loss ratio was 76.3% in 2003 compared to 51.5% in 2002. During the second quarter of 2003, we increased our gross losses by \$61.1 million on certain assumed accident and health reinsurance contracts reported in the discontinued line of business due to our processing of additional information received and our continuing evaluation of reserves related to this business. This had the effect of increasing our aggregate gross loss ratio by 13.2%. During the second quarter of 2002, we reduced our gross losses from the September 11 terrorist attacks by \$21.5 million which had the effect of reducing

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our gross loss ratio by 8.6%. As these assumed reinsurance contracts and September 11 losses were substantially reinsured, there was no material effect on our net losses.

The net loss experience in the diversified financial products line of business increased in 2003 as a result of a change in the mix of business as the line expands rapidly and our conservative reserving philosophy on new business. The London market account's net loss ratio was negatively affected in 2003 due to an increase in reserves in the accident and health category, some of which was adverse development from prior accident years. The net loss ratio in the aviation line of business increased slightly from the second quarter of 2002, due in part to some unusually large losses. Loss experience in the other specialty lines improved in 2003 compared to the prior year as it approached its expected level. The loss ratio in the discontinued lines of business increased in the second quarter of 2003 primarily due to prior year reserve development as we increased reserves towards the mid-point of the actuarial range.

Policy acquisition costs, which are net of commissions on reinsurance ceded, increased to \$34.0 million during the second quarter of 2003, from \$21.3 million in the same period in 2002. This increase is in proportion to the increase in net earned premium.

Net earnings of our insurance companies increased to \$19.8 million in the second quarter of 2003 from \$18.1 million for the same period in 2002 due to increased premium volume from rate increases, organic growth, a subsidiary acquired in 2002 and continuing profitable underwriting results somewhat offset by strengthening of prior period reserves and unusually high assessments from certain states and state agencies. We expect this growth to continue into 2004.

Underwriting Agencies

Revenue from our underwriting agencies (primarily fee income) increased 48% to \$40.0 million for the second quarter of 2003 compared to \$27.0 million for the same period in 2002. This growth was both from acquisitions made during 2002 and from internal growth, partially offset by decreases from underwriting agencies consolidated into our insurance companies during prior years. Net earnings in this segment increased to \$11.8 million in the second quarter of 2003 from \$6.2 million in 2002 for the same reasons and we expect this growth to continue into 2004.

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Intermediaries

Revenue from our intermediaries (primarily commission income) increased 36% to \$15.5 million for the second quarter of 2003 compared to \$11.4 million for the same period in 2002 due to improved market conditions, growth in non-affiliated business and from an acquisition made in 2002. Net earnings of our intermediaries increased to \$2.7 million for the second quarter of 2003 compared to \$2.4 million for the same period of 2002 for the same reasons. We expect this growth to continue in 2004.

Other Operations

The other operations segment saw an increase in revenue and segment net income due to income from our strategic investment in Argonaut Group, Inc. made in March 2003 and gains in our strategic investment and trading accounts as well as the initial consolidation of a real estate partnership to comply with FIN No. 46. Period to period comparisons may vary substantially depending on strategic investments, trading activities or dispositions in any given period.

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Corporate

The net earnings of the corporate segment were \$0.7 million for the second quarter of 2003 compared to net loss of \$0.1 million for the same period in 2002. This increase resulted from the difference between quarters in investment income, the interest expense allocated to subsidiaries and the \$1.3 million currency conversion gain in 2003. These items were partially offset by increases in compensation and depreciation expense between years.

Liquidity and Capital Resources

We receive substantial cash from premiums, reinsurance recoverables, management fees and commission income and, to a lesser extent, investment income and proceeds from sales and redemptions of investments and other assets. Our principal cash outflows are for the payment of claims and loss adjustment expenses, payment of premiums to reinsurers, purchase of investments, debt service, policy acquisition costs, operating expenses, income and other taxes and dividends. Variations in operating cash flows can occur due to timing differences in either the payment of claims and the collection of related recoverables or the collection of receivables and the payment of related payable amounts.

We maintain a substantial level of cash and liquid short-term investments which are used to meet anticipated payment obligations. Our consolidated cash and investment portfolio increased \$242.0 million, or 20%, during the first six months of 2003 and totaled \$1.4 billion as of June 30, 2003, of which \$413.2 million was cash and short-term investments. The increase in investments resulted from the positive operating cash flows and part of the proceeds from the 1.3% convertible notes discussed below.

In a public offering on March 25, 2003, we sold an aggregate \$125.0 million principal amount of 1.3% convertible notes due in 2023. Each one thousand principal amount of notes is convertible into 29.4377 shares of our common stock, which represents an initial conversion price of \$33.97 per share. The initial conversion price is subject to change under certain conditions. Interest is to be paid by us on April 1 and October 1 each year, commencing October 1, 2003. Holders may surrender notes for conversion into shares of our common stock if, as of the last day of the preceding calendar quarter, the closing sale price of our common stock for at least 20 consecutive trading days during the period of 30 consecutive trading days ending on the last trading day of that quarter is more than 130% (\$44.16 per share) of the conversion price per share of our common stock. We can redeem the notes for cash at any time on or after April 4, 2009. Holders of the notes may require us to repurchase the notes on April 1, 2009, 2014 and 2019 at a price equal to the principal amount of the notes plus accrued and unpaid interest. If the holders require us to repurchase these notes, we may choose to pay the purchase price in cash, in shares of our common stock, or in a combination thereof. We paid \$3.2 million in underwriting discounts and expenses in connection with this offering, which is being amortized from the issue

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date until April 1, 2009. We used \$66.0 million of the proceeds from this offering to pay down existing indebtedness under our bank facility, while the remainder is available to assist in financing future acquisitions and strategic investments and for general corporate purposes.

Reinsurance recoverables increased during the first six months of 2003 due to the increase in reinsurance recoverables on incurred but not reported losses. A significant portion of this increase comes from the diversified financial products line of business, new in 2002, which is more heavily reinsured than our

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other lines of business. The increase in gross losses on certain assumed contracts in the discontinued line of business also contributed to the increase.

We have a reserve of \$9.6 million as of June 30, 2003 for potential collectibility issues and associated expenses related to reinsurance recoverables. The adverse economic environment in the worldwide insurance industry, the decline in the market value of investments in equity securities and the terrorist attack on September 11, 2001 have placed great pressure on certain reinsurers and the results of their operations. Ultimately, these conditions could affect reinsurers' solvency. Historically, there have been insolvencies following a period of competitive pricing in the industry. We limit our exposure by holding funds, letters of credit or other security such that net balances due are significantly less than the gross balances shown in our condensed consolidated balance sheets. While we believe that the reserve is adequate based on currently available information, conditions may change or additional information might be obtained which may result in a future change in the reserve. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

A number of reinsurers have delayed or suspended the payment of amounts recoverable under certain reinsurance contracts to which we are a party. Such delays have affected, although not materially to date, the investment income of our insurance companies, but not to any extent their liquidity. In some instances, the reinsurers have withheld payment without reference to a substantive basis for the delay or suspension. In other cases, the reinsurers have claimed they are not liable for payment to us of all or part of the amounts due under the applicable reinsurance agreement. We believe these claims are substantially without merit and expect to collect the full amounts recoverable. We are currently in negotiations with most of these parties, but if such negotiations do not result in a satisfactory resolution of the matters in question, we may seek or be involved in a judicial or arbitral determination of these matters. In some cases, the final resolution of such disputes through arbitration or litigation may extend over several years. In this regard, as of June 30, 2003, our insurance companies had initiated two litigation proceedings against reinsurers. As of such date, our insurance companies had an aggregate amount of \$5.7 million which had not been paid to us under the agreements and we estimate that there could be up to an additional \$8.7 million of incurred losses and loss expenses and other balances which could become due under the subject agreements.

We believe that our operating cash flows, short-term investments, bank facility and shelf registration on file with the United States Securities and Exchange Commission will provide sufficient sources of liquidity to meet our operating needs for the foreseeable future.

Critical Accounting Policies

We have made no changes in our methods of application of our critical accounting policies from the information provided in our Annual Report on Form 10-K for the year ended December 31, 2002.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risk from the information provided in Item 7A. "Quantitative and Qualitative Disclosures About Market Risk" in our Annual Report on Form 10-K for the year ended December 31, 2002.

ITEM 4. CONTROLS AND PROCEDURES

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a. Evaluation of disclosure controls and procedures.

Within the 90 days prior to the date of this report, we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. This evaluation was performed under the supervision of, and with the participation of, our management, including the Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to HCC Insurance Holdings, Inc. and its subsidiaries required to be included in our periodic SEC filings.

b. Changes in internal controls.

There have been no changes in our internal controls or in other factors which could materially affect internal controls over financial reporting subsequent to the date we carried out our evaluation.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

In addition to the matters discussed in Note (2) Reinsurance, we are party to numerous lawsuits and other proceedings that arise in the normal course of our business. Many of such lawsuits and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits and other proceedings which relate to disputes over contractual relationships with third parties, or which involve alleged errors and omissions on the part of our subsidiaries. In addition, we are presently engaged in litigation initiated by the appointed liquidator of a former reinsurer concerning payments made to us prior to the date of the appointment of the liquidator. The disputed payments were made by the now insolvent reinsurer in connection with a commutation agreement. Our understanding is that such litigation is one of a number of similar actions brought by the liquidator. We intend to vigorously contest the action. We do not believe the resolution of any of these matters, some of which include allegations of damages of material amounts, will have a material adverse effect on our financial condition, results of operations or cash flows.

Item 4. Submission of Matters to Vote of Security Holders

On May 15, 2003, we held our 2003 Annual Meeting of Shareholders. At such time the following item was submitted to a vote of shareholders through the solicitation of proxies:

Election of Directors.

The following persons were elected to serve on the Board of Directors until the 2004 Annual Meeting of Shareholders or until their successors have been duly elected and qualified.

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The Directors received the votes set forth opposite their respective names:

| NAME ----- | FOR ----- | VOTES WITHHELD ----- |
|-----------------------|--------------|----------------------------|
| Stephen L. Way | 47,098,431 | 4,427,340 |
| Frank J. Bramanti | 47,642,448 | 3,883,323 |
| Patrick B. Collins | 46,835,903 | 4,689,868 |
| James R. Crane | 46,831,878 | 4,693,893 |
| J. Robert Dickerson | 46,836,778 | 4,688,993 |
| Edward H. Ellis, Jr. | 47,642,023 | 3,883,748 |
| James C. Flagg, Ph.D. | 46,835,693 | 4,690,078 |
| Allan W. Fulkerson | 47,643,080 | 3,882,691 |
| Walter J. Lack | 46,831,778 | 4,693,993 |
| Michael A. F. Roberts | 46,830,114 | 4,695,657 |

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Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 31.1 Certification by Chief Executive Officer.
- 31.2 Certification by Chief Financial Officer.
- 32.1 Certification with respect to quarterly report.

(b) Reports on Form 8-K

On May 8, 2003, we reported on Form 8-K our announcement of financial results for the first quarter of 2003.

On May 12, 2003, we reported on Form 8-K/A an amendment to our announcement of financial results for the first quarter of 2003.

On June 25, 2003, we furnished on Form 8-K the text materials used for presentations at various investor conferences.

SIGNATURES

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

HCC Insurance Holdings, Inc.

(Registrant)

March 1, 2004

/s/ Stephen L. Way

(Date)

Stephen L. Way, Chairman of the Board,
Chief Executive Officer and President

March 1, 2004

/s/ Edward H. Ellis, Jr.

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(Date)

Edward H. Ellis, Jr., Executive Vice
President and Chief Financial Officer

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