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HCC INSURANCE HOLDINGS INC/DE/  
Form 10-Q  
May 14, 2003

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

- ☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended March 31, 2003.
- ☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
- from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-20766

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 May 6, 2003, there were 62.8 million shares of common stock, \$1.00 par value issued and outstanding.

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This report on Form 10-Q 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.

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

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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)

March 31, 200

#### ASSETS

##### Investments:

Fixed income securities, at market	
(cost: 2003 - \$821,003; 2002 - \$807,772)	\$ 854,671
Marketable equity securities, at market	
(cost: 2003 - \$15,331; 2002 - \$15,815)	15,132
Short-term investments, at cost, which approximates market	455,604
Other investments, at estimated fair value	
(cost: 2003 - \$2,175; 2002 - \$3,264)	2,175

Total investments	1,327,582
-------------------	-----------

Cash	18,776
Restricted cash	208,150
Premium, claims and other receivables	814,199
Reinsurance recoverables	845,966
Ceded unearned premium	188,655
Ceded life and annuity benefits	78,675
Deferred policy acquisition costs	80,959
Goodwill	336,945
Other assets	162,521

TOTAL ASSETS	\$4,062,428
--------------	-------------

#### LIABILITIES

Loss and loss adjustment expense payable	\$1,234,211
Life and annuity policy benefits	78,675
Reinsurance balances payable	195,494
Unearned premium	387,274
Deferred ceding commissions	56,708

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Premium and claims payable	810,028
Notes payable	311,692
Accounts payable and accrued liabilities	75,454
	-----
Total liabilities	3,149,536
SHAREHOLDERS' EQUITY	
Common stock, \$1.00 par value; 250.0 million shares authorized; (shares issued and outstanding: 2003 - 62,679; 2002 - 62,358)	62,679
Additional paid-in capital	420,692
Retained earnings	409,579
Accumulated other comprehensive income	19,942
	-----
Total shareholders' equity	912,892
	-----
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$4,062,428
	=====

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 three 2003
		-----
REVENUE		
Net earned premium	\$	162,
Management fees		24,
Commission income		11,
Net investment income		10,
Net realized investment gain (loss)		
Other operating income		
		-----
Total revenue		210,
EXPENSE		
Loss and loss adjustment expense		100,
Operating expense:		
Policy acquisition costs, net		20,
Compensation expense		26,
Other operating expense		14,
		-----
Net operating expense		61,
Interest expense		1,

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Total expense	163,
Earnings before income tax provision	47,
Income tax provision	16,
Net earnings	\$ 30,
BASIC EARNINGS PER SHARE DATA:	
Earnings per share	\$ 0
Weighted average shares outstanding	62,
DILUTED EARNINGS PER SHARE DATA:	
Earnings per share	\$ 0
Weighted average shares outstanding	63,
Cash dividends declared, per share	\$ 0.

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 three months ended March 31, 2003 and  
for the year ended December 31, 2002

(unaudited, in thousands, except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income
BALANCE AS OF DECEMBER 31, 2001	\$ 61,438	\$ 402,089	\$ 293,426	\$ 6,500
Net earnings	--	--	105,828	--
Other comprehensive income	--	--	--	14,265
Comprehensive income				

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817 shares of common stock issued for exercise of options, including tax benefit of \$4,030	817	14,420	--	--
Issuance of 103 shares of contractually issuable common stock	103	(103)	--	--
Cash dividends declared, \$0.255 per share	--	--	(15,876)	--
	-----	-----	-----	-----
BALANCE AS OF DECEMBER 31, 2002	\$ 62,358	\$ 416,406	\$ 383,378	\$ 20,765
	=====	=====	=====	=====

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 three months ended March 31, 2003 and  
for the year ended December 31, 2002

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

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income
	-----	-----	-----	-----
BALANCE AS OF DECEMBER 31, 2002	\$ 62,358	\$ 416,406	\$ 383,378	\$ 20,765
Net earnings	--	--	30,275	--
Other comprehensive income (loss)	--	--	--	(823)
Comprehensive income				
269 shares of common stock issued for exercise of options, including tax benefit of \$876	269	4,338	--	--
Issuance of 52 shares of contractually issuable common stock	52	(52)	--	--
Cash dividends declared, \$0.065 per share	--	--	(4,074)	--
	-----	-----	-----	-----
BALANCE AS OF MARCH 31, 2003	\$ 62,679	\$ 420,692	\$ 409,579	\$ 19,942
	=====	=====	=====	=====

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 three months ended 2003
Cash flows from operating activities:	
Net earnings	\$ 30,
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Change in premium, claims and other receivables	(62,
Change in reinsurance recoverables	(47,
Change in ceded unearned premium	(24,
Change in loss and loss adjustment expense payable	78,
Change in reinsurance balances payable	28,
Change in unearned premium	56,
Change in premium and claims payable, net of restricted cash	41,
Depreciation and amortization expense	2,
Other, net	(3,
Cash provided by operating activities	101,
Cash flows from investing activities:	
Sales of fixed income securities	95,
Maturity or call of fixed income securities	27,
Sales of equity securities	
Change in short-term investments	(148,
Cost of securities acquired	(164,
Purchases of property and equipment	(1,
Cash used by investing activities	(190,
Cash flows from financing activities:	
Proceeds from notes payable, net of costs	134,
Sale of common stock	3,
Payments on notes payable	(67,
Dividends paid and other, net	(4,
Cash provided (used) by financing activities	66,
Net change in cash	(21,
Cash at beginning of period	40,
CASH AT END OF PERIOD	\$ 18,

See Notes to Condensed Consolidated Financial Statement

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 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, and the condensed consolidated statement of changes in shareholders' equity for the year then ended were derived from audited financial statements, but do not include all disclosures required by accounting principles generally accepted in the United States of America.

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 three months ended March 31, 2002 do not contain any activity generated by these three entities. We are still in the process of completing the purchase price allocations for two of these acquisitions, as we are still gathering some of the information needed to make the required calculations and, additionally, in the case of HCC Europe, we have not yet completed the final determination of the purchase price, which will be based upon an agreed-upon final closing date balance sheet. Any subsequent net adjustment will result in a change to recorded goodwill.

During the first quarter of 2003, we adopted prospectively Financial



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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.

### Income Tax

For the three months ended March 31, 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.

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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

##### Stock Options

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 income and earnings per share if we had used the fair value method of SFAS No. 123 entitled "Accounting for Stock-Based Compensation".

	For the three months ended 2003	2002
	-----	-----
Reported net earnings	\$ 30,275	\$ 23,2
Stock-based compensation using the fair value method, net of income tax	(1,939)	(1,0
	-----	-----
Pro forma net earnings	\$ 28,336	\$ 22,1
	=====	=====
Reported basic earnings per share	\$ 0.48	\$ 0.
Fair value stock-based compensation	(0.03)	(0.
	-----	-----
Pro forma basic earnings per share	\$ 0.45	\$ 0.
	=====	=====

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Reported diluted earnings per share	\$ 0.48	\$ 0.
Fair value stock-based compensation	(0.03)	(0.
	-----	-----
Pro forma diluted earnings per share	\$ 0.45	\$ 0.
	=====	=====

## Reclassifications

Certain amounts in our 2002 condensed consolidated financial statements have been reclassified to conform to the 2003 presentation. Such reclassifications had no effect on our net earnings, shareholders' equity or cash flows.

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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

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 three months ended March 31, 2003:		
Direct business	\$ 296,780	\$ 255,
Reinsurance assumed	82,668	61,
Reinsurance ceded	(186,947)	(155,
	-----	-----
NET AMOUNTS	\$ 192,501	\$ 162,
	=====	=====
For the three months ended March 31, 2002:		
Direct business	\$ 192,090	\$ 184,
Reinsurance assumed	55,678	49,

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Reinsurance ceded	(125,496)	(122,
	-----	-----
NET AMOUNTS	\$ 122,272	\$ 111,
	=====	=====

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

	March 31, 2003
	-----
Reinsurance recoverable on paid losses	\$ 117,63
Reinsurance recoverable on outstanding losses	289,51
Reinsurance recoverable on incurred but not reported losses	446,54
Reserve for uncollectible reinsurance	(7,73
	-----
TOTAL REINSURANCE RECOVERABLES	\$ 845,96
	=====

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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

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.

	March 31, 2003
	-----
Payables to reinsurers	\$ 268,777
Letters of credit	140,979
Cash deposits	9,014
	-----
TOTAL CREDITS	\$ 418,770
	=====

The tables below present the calculation of net reserves, net unearned

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premium and net deferred policy acquisition costs:

	March 31, 2003
	-----
Loss and loss adjustment expense payable	\$ 1,234,211
Reinsurance recoverable on outstanding losses	(289,516)
Reinsurance recoverable on incurred but not reported losses	(446,548)
	-----
NET RESERVES	\$ 498,147
	=====
Unearned premium	\$ 387,274
Ceded unearned premium	(188,655)
	-----
NET UNEARNED PREMIUM	\$ 198,619
	=====
Deferred policy acquisition costs	\$ 80,959
Deferred ceding commissions	(56,708)
	-----
NET DEFERRED POLICY ACQUISITION COSTS	\$ 24,251
	=====

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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 \$7.7 million as of March 31, 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 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.

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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 March 31, 2003, our insurance companies had initiated two litigation proceedings against reinsurers. As of such date, our insurance companies had an aggregate amount of \$4.2 million which had not been paid to us under the agreements and we estimate that there could be up to an additional \$9.5 million of incurred losses and loss expenses and other balances which 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.

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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	Other Operations
<hr/>				
For the three months ended March 31, 2003:				
Revenue:				
Domestic	\$ 128,860	\$ 21,094	\$ 5,539	\$ 447
Foreign	43,889	4,576	6,267	--
Inter-segment	--	11,739	217	--
	<hr/>			

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TOTAL SEGMENT REVENUE	\$ 172,749	\$ 37,409	\$ 12,023	\$ 447
=====				
Inter-segment revenue				
CONSOLIDATED TOTAL REVENUE				
Net earnings:				
Domestic	\$ 15,973	\$ 8,745	\$ 1,542	\$ (590)
Foreign	3,387	1,171	1,157	--
-----				
TOTAL SEGMENT NET EARNINGS (LOSS)	\$ 19,360	\$ 9,916	\$ 2,699	\$ (590)
=====				
Inter-segment eliminations				
CONSOLIDATED NET EARNINGS				
Other items:				
Net investment income	\$ 10,030	\$ 749	\$ 184	\$ 4
Depreciation and amortization	821	1,595	82	239
Interest expense (benefit)	9	1,812	638	193
Capital expenditures	440	517	301	--
Income tax provision (benefit)	8,761	5,834	2,021	(282)
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	Other Operations
-----				
For the three months ended March 31, 2002:				
Revenue:				

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Domestic	\$	103,413	\$	19,706	\$	5,139	\$	293
Foreign		16,795		507		5,243		--
Inter-segment		--		6,135		256		--

TOTAL SEGMENT REVENUE	\$	120,208	\$	26,348	\$	10,638	\$	293
-----------------------	----	---------	----	--------	----	--------	----	-----

Inter-segment revenue

CONSOLIDATED TOTAL REVENUE

Net earnings:								
Domestic	\$	14,364	\$	5,235	\$	565	\$	65
Foreign		536		258		1,144		--

TOTAL SEGMENT NET EARNINGS	\$	14,900	\$	5,493	\$	1,709	\$	65
----------------------------	----	--------	----	-------	----	-------	----	----

Inter-segment eliminations

CONSOLIDATED NET EARNINGS

Other items:								
Net investment income	\$	7,692	\$	715	\$	222	\$	20
Depreciation and amortization		758		1,607		86		50
Interest expense (benefit)		73		1,986		644		--
Capital expenditures		502		424		290		--
Income tax provision (benefit)		7,319		3,137		1,701		(9)
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 revenue by line of business within each operating segment for the periods indicated:

For the th

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2003

## Insurance company:

Group life, accident and health	\$	71,
Diversified financial products		18,
London market account		29,
Aviation		23,
Other specialty lines of business		9,
		-----
		153,
Discontinued lines of business		9,
		-----
TOTAL NET EARNED PREMIUM	\$	162,
		=====

## Underwriting agency:

Group life, accident and health	\$	8,
Property and casualty		16,
		-----
TOTAL MANAGEMENT FEES	\$	24,
		=====

## Intermediary:

Group life, accident and health	\$	8,
Property and casualty		3,
		-----
TOTAL COMMISSION INCOME	\$	11,
		=====

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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:



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	For the three mo 2003
	-----
Net earnings	\$ 30,275 =====
Reconciliation of number of shares outstanding:	
Shares of common stock outstanding at period end	62,679
Effect of common shares issued during the period	(42)
Common shares contractually issuable in the future	--
	-----
Weighted average common shares outstanding	62,637
Additional dilutive effect of outstanding options (as determined by the application of the treasury stock method)	698
	-----
Weighted average common shares and potential common shares outstanding	63,335 =====
Anti-dilutive shares not included in computation	2,218 =====

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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.

	March 31, 2003
	-----
1.3% Convertible notes	\$ 125,000
2% Convertible notes	172,451
\$200 million revolving loan facility	--
Other debt	14,241
	-----
TOTAL NOTES PAYABLE	\$ 311,692 =====

In a public offering on March 25, 2003, we sold an aggregate \$125.0

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million principal amount of 1.3% Convertible Notes due in 2023. Each \$1 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 note 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 available to assist in financing future acquisitions and strategic investments and for general corporate purposes.

### (6) SUPPLEMENTAL INFORMATION

Supplemental information for the three months ended March 31, 2003 and 2002, is summarized below:

	2003
	-----
Interest paid	\$ 2,431
Income tax paid	5,931
Comprehensive income	29,452
Ceding commissions netted with policy acquisition costs	44,603

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

### (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

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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 are also presently engaged in litigation, along with other insurers, with a state health insurance association concerning the change in calculation methodology of its assessments. We do not believe the resolution of any of these matters 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

Three months ended March 31, 2003 versus three months ended March 31, 2002

#### Results of Operations

Total revenue increased 39% to \$210.7 million for the first quarter of 2003 from \$151.7 million for the same period in 2002. The revenue increase resulted from premium rate increases, increased business in all three operating segments and subsidiaries acquired during the fourth quarter of 2002.

Net investment income increased 27% to \$11.0 million for the first quarter of 2003 from \$8.7 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 \$101.9 million for the first quarter of 2003 compared to \$13.1 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 first quarter of 2003 our annualized, weighted average, tax equivalent yield was 3.9% compared to 4.7% for the same period in 2002.

Compensation expense increased to \$26.4 million during the first quarter of 2003 from \$19.6 million for the same period in 2002. Most of the increase is due to subsidiaries acquired during the fourth quarter of 2002. Other operating expense increased to \$14.8 million during the first quarter of 2003 compared to \$12.6 million in 2002 for the same reason.

Interest expense was \$1.7 million for the first quarter of 2003 compared to \$2.4 million for the same period in 2002. Included in the 2002 amount is \$1.1 million representing the amortization of underwriting discounts and expenses of our issuance related to our 2% convertible notes.

Income tax expense was \$17.0 million for the first quarter of 2003 compared to \$12.4 million for the same period in 2002. Our effective tax rate was 35.9% in the 2003 quarter compared to 34.8% in 2002.

Net earnings increased 30% to \$30.3 million, or \$0.48 per diluted share, for the first quarter of 2003 from \$23.3 million, or \$0.37 per diluted share, for the

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same period in 2002. The increase in net earnings resulted from continuing good margins on increasing revenue.

At March 31, 2003, total assets exceeded \$4.0 billion for the first time, shareholders equity was \$912.9 million and book value per share was \$14.56, up from \$14.15 as of December 31, 2002.

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## SEGMENTS

### 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 three months ended March 31, 2003:				
Group life, accident and health	\$ 139,320	\$ 76,185	\$ 71,983	
Diversified financial products	107,320	33,307	18,306	
London market accounts	60,718	37,232	29,376	
Aviation	44,531	20,679	23,882	
Other specialty lines of business	20,880	17,450	9,528	
	-----	-----	-----	-----
	372,769	184,853	153,075	
Discontinued lines of business	6,679	7,648	9,347	
	-----	-----	-----	-----
TOTALS	\$ 379,448	\$ 192,501	\$ 162,422	
	=====	=====	=====	

Expense Ratio

Combined Ratio

	Gross written premium	Net written premium	Net earned premium	
	-----	-----	-----	-----
For the three months ended March 31, 2002:				
Group life, accident and health	\$ 122,904	\$ 51,820	\$ 51,567	
Diversified financial products	15,813	7,341	2,703	
London market accounts	47,545	28,536	16,252	
Aviation	44,114	22,633	25,183	

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Other specialty lines of business	4,202	3,581	3,635
	-----	-----	-----
	234,578	113,911	99,340
Discontinued lines of business	13,190	8,361	12,138
	-----	-----	-----
 TOTALS	 \$ 247,768	 \$ 122,272	 \$ 111,478
	=====	=====	=====

Expense Ratio

Combined Ratio

Gross written premium increased 53% to \$379.4 million for the first quarter of 2003 from \$247.8 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 the diversified financial products line of business, which our insurance companies began writing in 2002. Net written premium for the first quarter of 2003 increased 57% to \$192.5 million and net earned premium increased 46% to \$162.4 million, both due principally to the growth in gross premium. The increase in premium is expected to continue throughout 2003 and into 2004.

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Loss and loss adjustment expense was \$100.0 million for the first quarter of 2003 compared to \$68.3 million for the same period in 2002. The net loss ratio was 61.6% for the first quarter of 2003 compared to 61.3% for the same period in 2002. For the same period, the gross loss ratio was 68.9% in 2003 compared to 69.3% in 2002. Prior year net reserve deficiency included in loss and loss adjustment expense approximated \$1.3 million for the first quarter of 2003 compared to a redundancy of \$1.8 million for the same period in 2002. The deficiency and redundancy resulted from the settlement of claims for different amounts than previously reserved.

The loss ratio in the aviation line of business increased slightly from the first quarter of 2002 principally due to some adverse development on a few old claims plus a bad month of March 2003. Loss experience in the other specialty lines improved in 2003 to a more usual level from the prior year. The loss ratio in the discontinued lines of business increased in the first quarter of 2003 primarily due to prior year reserve development as we increase reserves towards the mid level of the actuarial range.

Policy acquisition costs, which are net of commissions on reinsurance ceded, increased to \$20.5 million during the first quarter of 2003, from \$13.1 million in the same period in 2002. This increase is due to and in proportion to the increase in net earned premium.

Net earnings of our insurance companies increased to \$19.4 million in the first quarter of 2003 from \$14.9 million for the same period in 2002 due to increased premium volume and continuing profitable underwriting results. We expect this growth to continue into 2004.

### Underwriting Agencies

Management fees increased 28% to \$24.9 million for the first quarter of 2003

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compared to \$19.4 million for the same period in 2002. This growth was both from acquisitions made during the fourth quarter of 2002 and from internal growth at our underwriting agencies. Net earnings in this segment increased to \$9.9 million in the first quarter of 2003 from \$5.5 million in 2002 for the same reasons and we expect this growth to continue into 2004.

### Intermediaries

Commission income increased 13% to \$11.5 million for the first quarter of 2003 compared to \$10.2 million for the same period in 2002 due to improved market conditions and growth in non-affiliated business. Net earnings of our intermediaries increased to \$2.7 million for the first quarter of 2003 compared to \$1.7 million for the same period of 2002 for the same reason. We expect continued improvement in the intermediary segment during the remainder of 2003.

### Other Operations

There was very little activity in the other operations segment during either first quarter. Quarter to quarter comparisons may vary substantially depending on other operating investments or dispositions thereof in any given period.

### Corporate

The net loss of the corporate segment was \$0.2 million for the first quarter of 2003 compared to net earnings of \$1.3 million for the same period in 2002. This resulted from the difference between years in intersegment income tax adjustments and the adjustment of certain accruals to their ultimate liability, which positively affected the 2002 quarter.

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### 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 \$138.4 million, or 11%, during the first quarter of 2003 and totaled \$1.3 billion as of March 31, 2003 of which \$474.4 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 \$1 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

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

Reinsurance recoverables increased during the first quarter 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 other lines of business. Reinsurance recoverables on outstanding losses was slightly reduced during the first quarter of 2003, but this was offset by a slight increase in reinsurance recoverables on paid losses.

We have a reserve of \$7.7 million as of March 31, 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 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 March 31, 2003, our insurance companies had initiated two litigation proceedings against reinsurers. As of such date, our insurance companies had an aggregate

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amount of \$4.2 million which had not been paid to us under the agreements and we estimate that there could be up to an additional \$9.5 million of incurred losses and loss expenses and other balances which 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

#### 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-14. 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 significant changes in our internal controls or in other factors which could significantly affect internal controls subsequent to the date we carried out our evaluation.

## 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



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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 are also presently engaged in litigation, along with other insurers, with a state health insurance association concerning the change in calculation methodology of its assessments. We do not believe the resolution of any of these matters will have a material adverse effect on our financial condition, results of operations or cash flows.

### Item 6. Exhibits and Reports on Form 8-K

#### (a) Exhibits

- 99.1 Certification with respect to quarterly report.
- 99.2 Certification by Chief Executive Officer.
- 99.3 Certification by Chief Financial Officer.

#### (b) Reports on Form 8-K

On January 28, 2003, we furnished on Form 8-K the text material used for presentations at various investor conferences.

On February 20, 2003, we reported on Form 8-K our announcement of financial results for the fourth quarter and full year of 2002.

On March 3, 2003, we furnished on Form 8-K the text materials used for presentations at various investor conferences.

On March 28, 2003, we reported on Form 8-K our public offering of 1.3% Convertible Notes due in 2023 and filed various exhibits related thereto.

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### 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.

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(Registrant)

May 12, 2003

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(Date)

/s/ Stephen L. Way

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

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May 12, 2003

/s/ Edward H. Ellis, Jr.

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(Date)

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

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INDEX TO EXHIBIT

Exhibit No.  
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Description  
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99.1	Certification with respect to quarterly report.
99.2	Certification by Chief Executive Officer.
99.3	Certification by Chief Financial Officer.