

HCC INSURANCE HOLDINGS INC/DE/
Form 10-Q
May 07, 2012

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

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
for the Quarterly Period Ended March 31, 2012.**

.. **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 (State or other jurisdiction of incorporation or organization)	76-0336636 (IRS Employer Identification No.)
13403 Northwest Freeway, Houston, Texas (Address of principal executive offices)	77040-6094 (Zip Code)
(713) 690-7300	

(Registrant's telephone number, including area code)

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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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

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

On April 27, 2012, there were approximately 101.2 million shares of common stock outstanding.

HCC Insurance Holdings, Inc. and Subsidiaries

Table of Contents

	Page
<u>Part I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Balance Sheets</u> March 31, 2012 and December 31, 2011	5
<u>Consolidated Statements of Earnings</u> Three months ended March 31, 2012 and 2011	6
<u>Consolidated Statements of Comprehensive Income</u> Three months ended March 31, 2012 and 2011	7
<u>Consolidated Statement of Changes in Shareholders' Equity</u> Three months ended March 31, 2012	8
<u>Consolidated Statements of Cash Flows</u> Three months ended March 31, 2012 and 2011	9
<u>Notes to Consolidated Financial Statements</u>	10
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	23
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	40
<u>Item 4. Controls and Procedures</u>	40
<u>Part II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	41
<u>Item 1A. Risk Factors</u>	41
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	41
<u>Item 3. Defaults Upon Senior Securities</u>	41
<u>Item 4. Mine Safety Disclosures</u>	41
<u>Item 5. Other Information</u>	41
<u>Item 6. Exhibits</u>	42
<u>Signatures</u>	43

FORWARD-LOOKING STATEMENTS

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. These forward-looking statements reflect our current expectations and projections about future events and 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 growth of our business and operations, business strategy, competitive strengths, goals, plans, future capital expenditures and references to future successes may be considered forward-looking statements. Generally, words such as anticipate, believe, estimate, expect, intend, plan, probably or similar expressions indicate forward-looking statements.

Many risks and uncertainties may have an impact on the matters addressed in these forward-looking statements, which could affect our future financial results and performance, including, among other things:

the effects of catastrophe losses,

the cyclical nature of the insurance business,

inherent uncertainties in the loss estimation process, which can adversely impact the adequacy of loss reserves,

the impact of past and future potential credit market downturns, including any potential additional ratings downgrade and/or impairment or perceived impairment of the debt securities of sovereign issuers, including the United States of America,

the effects of emerging claim and coverage issues,

the effects of extensive governmental regulation of the insurance industry,

changes to the country's health care delivery system,

the effects, if any, of climate change, on the risks we insure,

potential credit risk with brokers,

the effects of industry consolidations,

our assessment of underwriting risk,

our retention of risk, which could expose us to potential losses,

the adequacy of reinsurance protection,

the ability and willingness of reinsurers to pay balances due us,

the occurrence of terrorist activities,

our ability to maintain our competitive position,

fluctuations in securities markets, including defaults, which may reduce the value of our investment assets, reduce investment income or generate realized investment losses,

changes in our assigned financial strength ratings,

our ability to raise capital and funds for liquidity in the future,

attraction and retention of qualified employees,

our ability to successfully expand our business through the acquisition of insurance-related companies,

impairment of goodwill,

the ability of our insurance company subsidiaries to pay dividends in needed amounts,

fluctuations in foreign exchange rates,

failure of, or loss of security related to, our information technology systems,

difficulties with outsourcing relationships, and

change of control.

We describe these risks and uncertainties in greater detail in Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2011.

These events or factors 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, 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 that are included in this Report, our inclusion of this information is not a representation by us or any other person that our objectives or plans will be achieved.

Our forward-looking statements speak only at 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.

HCC Insurance Holdings, Inc. and Subsidiaries

Consolidated Balance Sheets

(unaudited, in thousands except per share data)

	March 31, 2012	December 31, 2011 (as adjusted)
ASSETS		
Investments		
Fixed income securities available for sale, at fair value (amortized cost: 2012 \$5,385,432 and 2011 \$5,640,630)	\$ 5,992,827	\$ 5,718,834
Fixed income securities held to maturity, at amortized cost (fair value: \$163,136)	-	161,102
Short-term investments, at cost (approximates fair value)	221,087	133,917
Other investments, at fair value (amortized cost: 2012 and 2011 \$38,230)	38,571	35,897
Total investments	6,252,485	6,049,750
Cash	90,913	104,550
Restricted cash	196,451	229,821
Premium, claims and other receivables	601,507	688,732
Reinsurance recoverables	1,083,054	1,056,068
Ceded unearned premium	231,405	222,300
Ceded life and annuity benefits	60,636	61,061
Deferred policy acquisition costs	195,558	189,633
Goodwill	873,900	872,814
Other assets	179,042	122,549
Total assets	\$ 9,764,951	\$ 9,597,278
LIABILITIES		
Loss and loss adjustment expense payable	\$ 3,721,974	\$ 3,658,317
Life and annuity policy benefits	60,636	61,061
Reinsurance, premium and claims payable	366,293	366,499
Unearned premium	1,042,050	1,031,034
Deferred ceding commissions	65,916	62,364
Notes payable	563,829	478,790
Accounts payable and accrued liabilities	650,296	665,231
Total liabilities	6,470,994	6,323,296
SHAREHOLDERS EQUITY		
Common stock, \$1.00 par value; 250,000 shares authorized (shares issued: 2012 123,000 and 2011 122,720; outstanding: 2012 102,196 and 2011 104,101)	123,000	122,720
Additional paid-in capital	1,004,595	1,001,308
Retained earnings	2,496,539	2,429,818
Accumulated other comprehensive income	244,295	227,659
Treasury stock, at cost (shares: 2012 20,804 and 2011 18,619)	(574,472)	(507,523)
Total shareholders equity	3,293,957	3,273,982

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Total liabilities and shareholders equity	\$ 9,764,951	\$ 9,597,278
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See Notes to Consolidated Financial Statements.

HCC Insurance Holdings, Inc. and Subsidiaries

Consolidated Statements of Earnings

(unaudited, in thousands except per share data)

	Three months ended March 31,	
	2012	2011
REVENUE		
Net earned premium	\$ 547,141	\$ 508,480
Net investment income	57,010	51,595
Other operating income	5,201	7,321
Net realized investment gain (loss)	171	(559)
Other-than-temporary impairment credit losses	-	(3,129)
Total revenue	609,523	563,708
EXPENSE		
Loss and loss adjustment expense, net	328,928	347,586
Policy acquisition costs, net	69,444	69,843
Other operating expense	87,282	77,847
Interest expense	6,909	5,553
Total expense	492,563	500,829
Earnings before income tax expense	116,960	62,879
Income tax expense	34,376	15,889
Net earnings	\$ 82,584	\$ 46,990
Earnings per common share		
Basic	\$ 0.80	\$ 0.41
Diluted	\$ 0.79	\$ 0.41

See Notes to Consolidated Financial Statements.

HCC Insurance Holdings, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(unaudited, in thousands)

	Three months ended March 31,	
	2012	2011
Net earnings	\$ 82,584	\$ 46,990
Other comprehensive income (loss):		
Investment gains (losses):		
Investment gains (losses) during the period	21,640	(22,457)
Income tax charge (benefit)	7,303	(12,323)
Investment gains (losses), net of tax	14,337	(10,134)
Less reclassification adjustments for:		
Gains (losses) included in net earnings	171	(3,692)
Income tax charge (benefit)	60	(1,292)
Gains (losses) included in net earnings, net of tax	111	(2,400)
Net unrealized investment gains (losses)	14,226	(7,734)
Foreign currency translation adjustment	2,533	6,025
Income tax charge (benefit)	123	-
Foreign currency translation adjustment, net of tax	2,410	6,025
Other comprehensive income (loss)	16,636	(1,709)
Comprehensive income	\$ 99,220	\$ 45,281

See Notes to Consolidated Financial Statements.

HCC Insurance Holdings, Inc. and Subsidiaries

Consolidated Statement of Changes in Shareholders Equity

Three months ended March 31, 2012

(unaudited, in thousands except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Treasury stock	Total shareholders equity
Balance at December 31, 2011 (as previously reported)	\$ 122,720	\$ 1,001,308	\$ 2,447,850	\$ 227,659	\$ (507,523)	\$ 3,292,014
Cumulative effect of accounting change (deferred policy acquisition costs)	-	-	(18,032)	-	-	(18,032)
Balance at December 31, 2011 (as adjusted)	122,720	1,001,308	2,429,818	227,659	(507,523)	3,273,982
Net earnings	-	-	82,584	-	-	82,584
Other comprehensive income	-	-	-	16,636	-	16,636
Issuance of 94 shares for exercise of options, including tax effect	94	1,184	-	-	-	1,278
Purchase of 2,185 common shares	-	-	-	-	(66,949)	(66,949)
Stock-based compensation	186	2,103	-	-	-	2,289
Cash dividends declared, \$0.155 per share	-	-	(15,863)	-	-	(15,863)
Balance at March 31, 2012	\$ 123,000	\$ 1,004,595	\$ 2,496,539	\$ 244,295	\$ (574,472)	\$ 3,293,957

See Notes to Consolidated Financial Statements.

HCC Insurance Holdings, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(unaudited, in thousands)

	Three months ended March 31,	
	2012	2011
Operating activities		
Net earnings	\$ 82,584	\$ 46,990
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Change in premium, claims and other receivables	16,089	(29,384)
Change in reinsurance recoverables	(19,639)	(98,459)
Change in ceded unearned premium	(8,887)	35,386
Change in loss and loss adjustment expense payable	35,737	159,429
Change in unearned premium	10,545	(19,014)
Change in reinsurance, premium and claims payable, excluding restricted cash	17,802	(8,612)
Change in accounts payable and accrued liabilities	(44,098)	(5,680)
Stock-based compensation expense	2,373	3,072
Depreciation and amortization expense	4,605	4,449
Other, net	(22,141)	(6,119)
Cash provided by operating activities	74,970	82,058
Investing activities		
Sales of available for sale fixed income securities	65,103	48,932
Maturity or call of available for sale fixed income securities	145,713	186,908
Maturity or call of held to maturity fixed income securities	28,636	19,082
Cost of available for sale fixed income securities acquired	(230,283)	(522,918)
Change in short-term investments	(66,008)	228,608
Payments for purchase of businesses, net of cash received	(32,143)	(1,892)
Other, net	(3,443)	(7,500)
Cash used by investing activities	(92,425)	(48,780)
Financing activities		
Advances on line of credit	95,000	
Payments on line of credit	(10,000)	
Sale of common stock	1,278	20,525
Purchase of common stock	(62,358)	(35,709)
Dividends paid	(16,139)	(16,670)
Other, net	(3,963)	(498)
Cash provided (used) by financing activities	3,818	(32,352)
Net increase (decrease) in cash	(13,637)	926
Cash at beginning of year	104,550	97,857
Cash at end of period	\$ 90,913	\$ 98,783

See Notes to Consolidated Financial Statements.

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

(1) General Information

HCC Insurance Holdings, Inc. (HCC) and its subsidiaries (collectively we, us or our) include domestic and foreign property and casualty and life insurance companies and underwriting agencies with offices in the United States, the United Kingdom, Spain and Ireland. We underwrite a variety of non-correlated specialty insurance products, including property and casualty, accident and health, surety, credit, and aviation product lines, in approximately 180 countries. We market our products through a network of independent agents and brokers, producers, managing general agents and directly to customers.

Basis of Presentation

Our unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and include the accounts of HCC and its subsidiaries. We have made all adjustments that, in our opinion, are necessary for a fair statement of results of the interim periods, and all such adjustments are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2011. The consolidated balance sheet at December 31, 2011 was derived from the audited financial statements but does not include all disclosures required by GAAP.

Management must make estimates and assumptions that affect amounts reported in our consolidated financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. We have reclassified certain amounts in our 2011 consolidated financial statements to conform to the 2012 presentation. None of our reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

Accounting Guidance Adopted in 2012

Deferred Policy Acquisition Costs

A new accounting standard clarifies the definition of acquisition costs incurred by an insurance company and limits capitalization to such costs directly related to renewing or acquiring new insurance contracts. Under the new standard, we expense all costs incurred for unsuccessful marketing or underwriting efforts, along with indirect costs, as incurred. We adopted this guidance on January 1, 2012 through retrospective adjustment of the capitalized deferred policy acquisition costs, deferred income taxes and consolidated shareholders' equity in our prior years consolidated financial statements. We also reclassified expenses in our prior years' consolidated income statements to reflect the new definition of policy acquisition costs. Application of the new guidance did not impact our reported consolidated net earnings or cash flows in prior years. The following line items in our consolidated financial statements were affected by this change in accounting guidance:

	\$XXXXXXXX	\$XXXXXXXX	\$XXXXXXXX
	December 31, 2011		
	As originally reported	Change	As adjusted
Deferred policy acquisition costs	\$ 217,608	\$ (27,975)	\$ 189,633
Accounts payable and accrued liabilities (deferred income taxes)	675,174	(9,943)	665,231
Retained earnings	2,447,850	(18,032)	2,429,818

	\$XXXX,XXX,XX	\$XXXX,XXX,XX	\$XXXX,XXX,XX
	Three months ended March 31, 2011		
	As originally reported	Change	As adjusted
Policy acquisition costs, net	\$ 83,378	\$ (13,535)	\$ 69,843
Other operating expense	64,312	13,535	77,847

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

Goodwill Impairment

A new accounting standard simplifies how entities test goodwill for impairment. The new standard permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, as a basis for determining whether it is necessary to perform a two-step goodwill impairment test. Previous guidance required an entity to test goodwill for impairment, at least on an annual basis, by first comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit was less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the new rules, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that the reporting unit's fair value is less than its carrying amount. The new rules were effective for us on January 1, 2012. We do not expect application of the new guidance to have a material impact on our consolidated financial position, results of operations or cash flows.

(2) Investments

On March 31, 2012, we reclassified our entire portfolio of fixed income securities classified as held to maturity, which consisted of corporate fixed income, U.S. government and foreign government securities, to fixed income securities classified as available for sale. Financial markets recently have been disrupted by several events, including the European debt crisis and the August 2011 downgrade of U.S. government debt by Standard & Poor's Corporation. Due to these market disruptions and our desire to maintain greater flexibility in managing our entire investment portfolio in an uncertain economy, we changed our prior intent to hold these securities to maturity. On the date of transfer, these securities had a fair value of \$139.1 million and an amortized cost of \$136.0 million. The securities' net unrealized appreciation, net of tax, increased our accumulated other comprehensive income and shareholders' equity by \$2.0 million as of March 31, 2012.

The cost or amortized cost, gross unrealized gain or loss, and fair value of our fixed income securities were as follows:

	\$XXXXXX Cost or amortized cost	\$XXXXXX Gross unrealized gain	\$XXXXXX Gross unrealized loss	\$XXXXXX Fair value
March 31, 2012				
U.S. government and government agency securities	\$ 263,352	\$ 8,894	\$ (99)	\$ 272,147
Fixed income securities of states, municipalities and political subdivisions	992,522	83,508	(175)	1,075,855
Special purpose revenue bonds of states, municipalities and political subdivisions	1,801,978	129,297	(514)	1,930,761
Corporate fixed income securities	1,022,264	42,835	(1,612)	1,063,487
Residential mortgage-backed securities	991,349	58,432	(2,002)	1,047,779
Commercial mortgage-backed securities	258,961	19,787	(95)	278,653
Asset-backed securities	36,506	233	(1)	36,738
Foreign government securities	273,698	13,716	(7)	287,407
Total fixed income securities - available for sale	\$ 5,640,630	\$ 356,702	\$ (4,505)	\$ 5,992,827

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

	Cost or amortized cost	Gross unrealized gain	Gross unrealized loss	Fair value
December 31, 2011				
U.S. government and government agency securities	\$ 285,166	\$ 10,523	\$ (10)	\$ 295,679
Fixed income securities of states, municipalities and political subdivisions	999,940	85,528	(127)	1,085,341
Special purpose revenue bonds of states, municipalities and political subdivisions	1,741,297	122,746	(155)	1,863,888
Corporate fixed income securities	817,886	35,221	(6,774)	846,333
Residential mortgage-backed securities	1,036,436	65,771	(2,121)	1,100,086
Commercial mortgage-backed securities	244,535	15,162	(3,573)	256,124
Asset-backed securities	34,655	147	(56)	34,746
Foreign government securities	225,517	11,203	(83)	236,637
Total fixed income securities - available for sale	\$ 5,385,432	\$ 346,301	\$ (12,899)	\$ 5,718,834
U.S. government securities	\$ 6,998	\$ 69	\$ -	\$ 7,067
Corporate fixed income securities	110,284	1,814	(455)	111,643
Foreign government securities	43,820	746	(140)	44,426
Total fixed income securities - held to maturity	\$ 161,102	\$ 2,629	\$ (595)	\$ 163,136

Substantially all of our fixed income securities are investment grade and all securities were income producing in 2012. The following table displays the gross unrealized losses and fair value of all available for sale fixed income securities that were in a continuous unrealized loss position for the periods indicated.

	Less than 12 months		12 months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
March 31, 2012						
U.S. government and government agency securities	\$ 24,922	\$ (99)	\$ -	\$ -	\$ 24,922	\$ (99)
Fixed income securities of states, municipalities and political subdivisions	11,407	(155)	828	(20)	12,235	(175)
Special purpose revenue bonds of states, municipalities and political subdivisions	44,650	(494)	1,573	(20)	46,223	(514)
Corporate fixed income securities	97,215	(1,601)	1,419	(11)	98,634	(1,612)
Residential mortgage-backed securities	35,435	(396)	8,416	(1,606)	43,851	(2,002)
Commercial mortgage-backed securities	18,577	(95)	-	-	18,577	(95)
Asset-backed securities	2,855	(1)	-	-	2,855	(1)
Foreign government securities	4,684	(7)	-	-	4,684	(7)
Total	\$ 239,745	\$ (2,848)	\$ 12,236	\$ (1,657)	\$ 251,981	\$ (4,505)

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

	Less than 12 months		12 months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
December 31, 2011						
U.S. government and government agency securities	\$ 13,984	\$ (10)	\$ -	\$ -	\$ 13,984	\$ (10)
Fixed income securities of states, municipalities and political subdivisions	10,256	(107)	899	(20)	11,155	(127)
Special purpose revenue bonds of states, municipalities and political subdivisions	21,856	(67)	6,796	(88)	28,652	(155)
Corporate fixed income securities	154,856	(6,391)	18,005	(383)	172,861	(6,774)
Residential mortgage-backed securities	32,430	(1,364)	7,582	(757)	40,012	(2,121)
Commercial mortgage-backed securities	39,075	(3,573)	-	-	39,075	(3,573)
Asset-backed securities	19,648	(56)	-	-	19,648	(56)
Foreign government securities	4,198	(83)	-	-	4,198	(83)
Total	\$ 296,303	\$ (11,651)	\$ 33,282	\$ (1,248)	\$ 329,585	\$ (12,899)

A security has an impairment loss when its fair value is less than its cost or amortized cost at the balance sheet date. We evaluate our securities for possible other-than-temporary impairment losses at each quarter end. Our reviews cover all impaired securities where the loss exceeds \$0.5 million and the loss either exceeds 10% of cost or the security had been in a loss position for longer than twelve consecutive months. We recognized no other-than-temporary impairment losses in the first quarter of 2012 and \$3.1 million, all of which were recognized in earnings, in the first quarter of 2011.

We have recognized credit losses on certain impaired fixed income securities, for which each security also had an impairment loss recorded in other comprehensive income. The rollforward of these credit losses was as follows:

	Three months ended March 31,	
	2012	2011
Balance at beginning of year	\$ 5,047	\$ 4,273
Credit losses recognized in earnings	-	-
Securities previously impaired	-	1,247
Securities not previously impaired	-	1,838
Securities sold	-	(673)
Balance at March 31	\$ 5,047	\$ 6,685

We had \$0.6 million after-tax other-than-temporary impairment losses, related to mortgage-backed securities, included in accumulated other comprehensive income within shareholders' equity at March 31, 2012. This amount includes the after-tax unrealized gains and losses on these impaired securities resulting from changes in their fair value subsequent to their initial other-than-temporary impairment measurement dates.

We do not consider the \$4.5 million of gross unrealized losses on fixed income securities in our portfolio at March 31, 2012 to be other-than-temporary impairments because: 1) as of March 31, 2012, we have received substantially all contractual interest and principal payments on these securities, 2) we do not intend to sell these securities, 3) it is more likely than not that we will not be required to sell the securities before recovery of their amortized cost bases and 4) the unrealized loss relates to non-credit factors, such as interest rate changes and market conditions.

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

The amortized cost and fair value of our fixed income securities at March 31, 2012, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The weighted-average life of our mortgage-backed and asset-backed securities was 4.4 years at March 31, 2012.

	Cost or amortized cost	Fair value
Due in 1 year or less	\$ 379,129	\$ 386,378
Due after 1 year through 5 years	1,121,859	1,174,766
Due after 5 years through 10 years	1,170,245	1,267,353
Due after 10 years through 15 years	794,448	859,376
Due after 15 years	888,133	941,784
Securities with fixed maturities	4,353,814	4,629,657
Mortgage-backed and asset-backed securities	1,286,816	1,363,170
Total fixed income securities	\$ 5,640,630	\$ 5,992,827

The sources of net investment income were as follows:

	Three months ended March 31,	
	2012	2011
Fixed income securities		
Taxable	\$ 31,115	\$ 27,095
Exempt from U.S. income taxes	26,612	24,911
Total fixed income securities	57,727	52,006
Short-term investments	62	156
Other	467	642
Total investment income	58,256	52,804
Investment expense	(1,246)	(1,209)
Net investment income	\$ 57,010	\$ 51,595

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

(3) Fair Value Measurements

Our financial instruments include assets and liabilities carried at fair value, as well as assets and liabilities carried at cost or amortized cost but disclosed at fair value in our financial statements. In determining fair value, we generally apply the market approach, which uses prices and other relevant data based on market transactions involving identical or comparable assets and liabilities. We classify our financial instruments into the following three-level hierarchy:

Level 1 Inputs are based on quoted prices in active markets for identical instruments.

Level 2 Inputs are based on observable market data (other than quoted prices), or are derived from or corroborated by observable market data.

Level 3 Inputs are unobservable and not corroborated by market data.

Our Level 1 investments consist of U.S. Treasuries, money market funds, and equity securities traded in an active exchange market. We use unadjusted quoted prices for identical instruments to measure fair value.

Our Level 2 investments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, corporate debt securities, bank loans, and mortgage-backed and asset-backed securities. Level 2 also includes certificates of deposit and other interest-bearing deposits at banks, which we report as short-term investments. We measure fair value for the majority of our Level 2 investments using quoted prices of securities with similar characteristics. The remaining investments are valued using pricing models or matrix pricing. The fair value measurements consider observable assumptions, including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, default rates, loss severity and other economic measures.

We use independent pricing services to assist us in determining fair value for approximately 99% of our Level 2 investments. The pricing services provide a single price or quote per security. We use data provided by our third party investment managers to value the remaining Level 2 investments. To validate that these quoted and modeled prices are reasonable estimates of fair value, we perform various quantitative and qualitative procedures, including: 1) evaluation of the underlying methodologies, 2) analysis of recent sales activity, 3) analytical review of our fair values against current market prices and 4) comparison of the pricing services' fair value to other pricing services' fair value for the same investment. No markets for our investments were judged to be inactive at period end. Based on these procedures, we did not adjust the prices or quotes provided by our independent pricing services or third party investment managers as of March 31, 2012 or December 31, 2011.

Our Level 2 financial instruments also include our notes payable. We determine the fair value of our 6.30% Senior Notes based on quoted prices, but the market is inactive. The fair value of borrowings under our Revolving Loan Facility approximates the carrying amount because interest is based on 30-day LIBOR plus a margin.

Our Level 3 securities include certain fixed income securities and an insurance contract that we account for as a derivative and classify in other assets. We determine fair value of our Level 3 securities based on internally developed models that use assumptions or other data that are not readily observable from objective sources.

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited, tables in thousands except per share data)

The following tables present the fair value of our financial instruments that were carried or disclosed at fair value. Unless indicated, these items were carried at fair value on our consolidated balance sheet.

	\$179,050.00 Level 1	\$179,050.00 Level 2	\$179,050.00 Level 3	\$179,050.00 Total
March 31, 2012				
Fixed income securities - available for sale				
U.S. government and government agency securities	\$ 179,050	\$ 93,097	\$ -	\$ 272,147
Fixed income securities of states, municipalities and political subdivisions	-	1,075,855	-	1,075,855
Special purpose revenue bonds of states, municipalities and political subdivisions	-	1,930,761	-	1,930,761
Corporate fixed income securities	-	1,063,330	157	1,063,487
Residential mortgage-backed securities	-	1,047,779	-	1,047,779
Commercial mortgage-backed securities	-	278,653	-	278,653
Asset-backed securities	-	36,738	-	36,738
Foreign government securities	-	287,407	-	287,407
Total fixed income securities - available for sale	179,050	5,813,620	157	5,992,827
Short-term investments*	115,023	106,064	-	221,087
Other investments	38,396	-	-	38,396
Other assets	-	-	1,731	1,731
Total assets measured at fair value	\$ 332,469	\$ 5,919,684	\$ 1,888	\$ 6,254,041
Notes payable* - measured at fair value	\$ -	\$ 599,059	\$ -	\$ 599,059

December 31, 2011

Fixed income securities - available for sale
U.S. government and government agency securities