HCC INSURANCE HOLDINGS INC/DE/
Form 10-K
February 28, 2013
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**
For the fiscal year ended December 31, 2012

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	*(IRS Employer*
incorporation or organization)	*Identification No.)*
13403 Northwest Freeway,	**77040-6094**
Houston, Texas	*(Zip Code)*
(Address of principal executive offices)	

(713) 690-7300

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:	**Name of each exchange on which registered:**
Common Stock, $1.00 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes þ No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No þ

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 þ 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). þ Yes ¨ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 þ	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	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 þ

The aggregate market value on June 30, 2012 (the last business day of the registrant s most recently completed second fiscal quarter) of the voting stock held by non-affiliates of the registrant was approximately $3.1 billion. For purposes of the determination of the above-stated amount, only Directors and executive officers are presumed to be affiliates, but neither the registrant nor any such person concede that they are affiliates of the registrant.

The number of shares outstanding of the registrant s Common Stock, $1.00 par value, at February 15, 2013 was 100.6 million.

DOCUMENTS INCORPORATED BY REFERENCE:

Information called for in Part III of this Form 10-K is incorporated by reference to the registrant s definitive Proxy Statement to be filed within 120 days of the close of the registrant s fiscal year in connection with the registrant s annual meeting of shareholders.

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HCC INSURANCE HOLDINGS, INC.

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PART I.

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K 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, p 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 economic or 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 of climate change on the risks we insure,*
- *potential 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,

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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, 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.

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.

As used in this Report, unless otherwise required by the context, the terms we, us and our refer to HCC Insurance Holdings, Inc. and its consolidated subsidiaries and the term HCC refers only to HCC Insurance Holdings, Inc. All trade names or trademarks appearing in this Report are the property of their respective holders.

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PART I

Item 1. ***Business***

Business Overview

HCC Insurance Holdings, Inc. is a leading specialty insurer with offices in the United States, the United Kingdom, Spain and Ireland. We underwrite over 100 classes of specialty insurance products in approximately 180 countries through our five underwriting segments: U.S. Property & Casualty, Professional Liability, Accident & Health, U.S. Surety & Credit and International. Our principal executive office is located in Houston, Texas.

Our diverse portfolio of businesses is largely non-correlated and designed to generate consistent underwriting results regardless of market cycles. As a result, we have achieved an average combined ratio of 86.0% for the period 2008 2012, with less volatility over that period than our specialty peers. These profitable underwriting results have driven a continuing increase in shareholders equity over the past five years of 46%, while during the same period we paid $303.3 million in dividends to our shareholders and repurchased $686.2 million of our common stock. We generated 10.7% compounded growth in book value per share over that same period. We have been able to grow our gross written premium by 14% during the past five years as well, through a combination of organic growth and acquisitions.

We maintain financial strength ratings that are among the highest within the property and casualty insurance industry: AA (Very Strong) from Standard & Poor s Corporation, A+ (Superior) from A.M. Best Company, Inc., AA (Very Strong) from Fitch Ratings, and A1 (Good Security) from Moody s Investors Service, Inc. for our major domestic and international insurance companies. These ratings provide a competitive advantage in many of our chosen lines of business.

Our Strategy

Our organization is focused on generating consistent, industry-leading combined ratios. By focusing on underwriting profitability, we are able to accomplish our primary objectives of maximizing net earnings and growing book value per share. We are aligned with this strategy through our culture and our performance incentives.

Key elements of our strategy are discussed below:

Diverse, Non-correlated Specialty Lines of Business

We concentrate our insurance writings in diverse specialty lines of business in which we believe we can achieve meaningful underwriting profits and, collectively, generate combined ratios consistently in the mid-80s. The diversity of our product lines results in our operating within five insurance underwriting segments that are largely non-correlated, meaning that insurance or economic cycles impacting one segment may not impact other segments or impact them to a lesser degree. We intentionally built the company around these non-correlated products as we believe this approach increases our chances of generating consistent underwriting results over time and through market cycles.

Our product diversity also provides operational flexibility, which permits us to shift the focus of our insurance underwriting activities among our various lines of business, emphasizing more profitable lines of business during periods of increased premium rates and de-emphasizing less profitable lines during periods of increased competition. We accomplish these shifts by increasing or decreasing the amount of gross premium written or by adjusting the amount of business reinsured.

Experienced Underwriting Professionals Aligned with Our Strategy

Integral to our strategy is attracting, developing and retaining professionals with the requisite skills and knowledge to underwrite our diverse specialty product lines. These professionals include experienced underwriters in our chosen specialty lines with the authority to make decisions and quickly respond to our clients unique and rapidly changing needs. Our senior underwriters have been with HCC or our acquired companies more than ten years.

Our underwriters are aligned with our strategy and underwriting culture. This alignment is reinforced by our compensation practices, which are designed to reward disciplined underwriting and the generation of underwriting profit above all other measures. As a result, our underwriters have the expertise, mind-set and incentives to utilize the operational flexibility afforded by our diverse specialty lines of business.

Low Expense Ratio

Core to our overall underwriting performance is the maintenance of a low expense ratio. We accomplish this through disciplined expense management and a flat management structure. We also have a relatively small operational footprint despite the international breadth of our product offerings. We have resisted the tendency for the proliferation of branch offices in the United States and have centered our international business in London and Barcelona where we believe we have access to the lines of specialty international business that we desire.

New Lines of Business and Growth

We have historically accomplished significant growth through the successful acquisition and integration of insurance companies and underwriting agencies, making nearly 50 acquisitions since becoming a public company in 1992. In recent years, we have also actively recruited and hired new underwriting teams that we believe present opportunities for future profit and expansion of our business. We expect to continue to acquire complementary businesses and underwriting teams, while organically growing our current businesses. In considering new teams and potential acquisitions, we remain disciplined in pursuing those that meet our requirements for return on risk-adjusted capital and cultural fit. We believe our infrastructure, ratings and financial strength provide a solid operating platform for our future growth.

Effective Use of Reinsurance

Our financial strength and the profitability of our products provide significant flexibility with respect to the amount and types of reinsurance we buy. Our bias is towards retaining our business, which allows us to be flexible in our reinsurance purchases. Accordingly, the amount of reinsurance we purchase varies depending on the particular risks inherent in the policies underwritten; the pricing, coverage and terms of the reinsurance; and the competitive conditions within the relevant lines of business. Historically, we have purchased more reinsurance on new lines of business where we have less experience. As we gain experience with these new lines of business, we generally retain more of the business. When we decide to retain more underwriting risk in a particular line of business, we do so to retain more of the expected profitability of the business.

Disciplined Investment Portfolio

Our investment objective is to protect and conservatively grow the cash flows and profits generated by our insurance underwriting segments. Our investments include both highly-rated fixed maturity securities and, more recently, equity securities with attractive dividend yields. With both of these investment classes, we have a buy and hold investment philosophy that is focused on maximizing after-tax net investment income while limiting our exposure to investment losses. At all times, we are grounded in our primary organizational goal of generating the majority of our profits through our insurance operations as opposed to taking significant credit or market risk in our investment portfolio.

Segment and Geographic Information

For financial information concerning our operations by segment and geographic data, see Segment Operations included in Management s Discussion and Analysis and Note 12, Segments to the Consolidated Financial Statements.

Insurance Underwriting Operations

Our insurance operations are managed within our insurance underwriting segments. The following provides an overview of each of these segments.

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U.S. Property & Casualty Segment

Our U.S. Property & Casualty segment includes specialty lines of insurance such as aviation, small account errors and omissions liability (E&O), public risk, contingency, disability, title and mortgage reinsurance, residual value, employment practices liability (EPLI), technical property, primary and excess casualty, and brown water marine written in the U.S. The majority of the business is primary coverage, and claims are reported and settled on a short to medium-term basis. The aviation, public risk, contingency, technical property and brown water marine lines are exposed to natural peril and other catastrophic occurrences. Business is produced from wholesale and specialty retail brokers. A portion of our aviation business is written on a direct to consumer basis.

Key lines of business within this segment are described below:

Aviation

Aviation insurance has been a core business for us since 1974. In the United States, we are an industry leader, providing customized coverages for both private and commercial aircraft operators, excluding major U.S. airlines. Private coverage includes planes ranging in size from small single-engine aircraft to executive jets. With our commercial and special risk products, we provide coverage for risks such as air ambulances, vintage war birds and rotor wing aircraft. We also write aviation business internationally, including complex accounts such as national armed forces, law enforcement agencies and regional airlines. We are the lead underwriter on numerous policies in our international aviation portfolio.

Small Account E&O

Our small account E&O business consists of policies with low limits ($5.0 million or less). We provide E&O coverage to many classes of professional service providers, of which architects, engineers and related construction practices represent the largest concentration of insured professionals. Managing general agencies that we have acquired have provided insurance and risk management services for more than twenty years to these classes. We do not write a material amount of E&O coverage for the legal, medical or accounting professions. Our E&O business is produced through both wholesale and specialty retail brokers and is underwritten on both an admitted and surplus lines basis.

Public Risk

We provide insurance coverage and associated risk management services to municipal entities and special districts, mainly serving populations of less than 50,000 in the United States. Types of coverage provided include automobile physical damage, automobile liability, boiler and machinery, crime, EPLI, general liability, inland marine, law enforcement liability, public officials liability, and property. We typically write large limits (greater than $10.0 million) for property coverage, and low limits and medium limits ($5.0 million to $10.0 million) for the other types of coverage.

Contingency and Disability

As a leader in the contingency market, we provide weather insurance and event cancellation, covering events such as collegiate championships, All-Star Games and large musical concerts. We also write kidnap and ransom insurance, providing coverage throughout the world. In addition, we are a leading underwriter of specialty disability products, providing coverage of irreplaceable human assets, such as high profile athletes, entertainers and business executives. We write large limits and purchase significant proportional and excess of loss reinsurance to manage our contingency exposures.

Casualty

We began this business in 2011 with two new underwriting teams focused on writing primary general liability and excess casualty coverages. The primary casualty unit typically writes low limit policies on a surplus lines basis through wholesale brokers. The excess casualty unit also typically operates on a surplus lines basis through wholesale brokers, but these policies typically have medium limits. The attachment points for excess policies are typically below $25.0 million. Due to the

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underlying nature of the claims associated with casualty business, the final settlement value of claims may not be determined for long periods of time.

Professional Liability Segment

Our Professional Liability segment primarily consists of our directors and officers (D&O) liability business. In addition, we write related professional liability and crime business coverages, including large account E&O liability, fiduciary liability, fidelity and bankers blanket bonds, and EPLI for some D&O policyholders. The business is written for both U.S.-based and International-based policyholders from our offices in the United States, the United Kingdom and Spain. A significant amount of the business is received from major worldwide insurance brokerage companies. Along with the specialization and experience of our underwriters, HCC s financial strength ratings help us maintain a competitive position in our D&O business.

We write both primary and excess policies for public and private companies. Our policies cover a large number of commercial classes and financial institution classes, which include investment banks, depository institutions, private equity companies, insurance companies and brokers and investment advisors. A large amount of the public company and financial institution business is large limit that is subject to severity of loss on individual policies, as well as fluctuations in frequency of loss from changes in world-wide business and economic environments. Coverage is typically provided through claims made policies. However, the final settlement value of claims may not be determined for long periods of time due to the underlying nature of the claims, which involve complex litigation by third parties against our insureds.

Accident & Health Segment

Our Accident & Health segment includes medical stop-loss and short-term domestic and international medical products written in the United States. The majority of the business covers groups of employees, and claims are reported and settled quickly.

We are a recognized market leader in the specialty accident and health industry. Since 1996, we have achieved growth primarily through numerous acquisitions and ongoing development of innovative products. As a result of our acquisitions, we have fortified our market position and retained an experienced senior management team. Our more recent growth has been organic as we leverage our scale and relationships with brokers. Our specialized product line combined with disciplined underwriting, innovative claims management and cost-efficient operations provides a superior operating margin for this segment.

Key lines of business within this segment are described below:

Medical Stop-Loss

Medical stop-loss insurance provides protection for catastrophic losses to employers that self-fund their employee benefit plans. We deliver this insurance to employers through insurance brokers, consultants and third party administrators. Our underwriting offices are strategically located throughout the United States, allowing us to geographically manage the business. Our highly-trained medical stop-loss claims unit exclusively deals with the complex nature of catastrophic health claims and works closely with employers and their plan administrators to control plan costs.

Short-term Domestic and International Medical

Our short-term medical insurance provides temporary coverage, up to eleven months, for individuals in the United States without primary insurance during transitional periods. Our international medical insurance plans provide health insurance and specialized travel services to individuals outside their home country. Several types of international medical products are offered, including short and long-term individual and group plans. Both the short-term domestic and international medical products are purchased through an Internet portal accessed by consumers, brokers and consultants.

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U.S. Surety & Credit Segment

Our U.S. Surety & Credit segment conducts business through separate specialty surety underwriting operations and credit underwriting operations, which are described below:

Surety

Our surety business includes contract surety bonds, commercial surety bonds and bail bonds. A large amount of our contract surety book is characterized by relatively small limits and premiums. Significant classes within commercial surety are license and permit bonds, court bonds for fiduciaries as well as appeal bonds, and plug and abandonment bonds for the energy sector. Most of our commercial surety bond business is also small limit and small premium business, but we also have a modest large commercial surety business that has large limits. Our surety business is typically received from a large number of independent agents specializing in these coverages or from specialized units of large brokerage companies.

The surety industry has lower expected loss ratios and higher expense ratios than most areas of the property and casualty insurance industry. The lower expected loss ratios reflect the fact that the bond serves as financial protection to a third party in the event a principal is unable to honor an obligation, rather than an insurance policy that pays on behalf of a policyholder. In the event of a claim against a bond, we often receive subrogation recovery against the loss, including recovery from the bond principal. The higher expense ratios result from higher acquisition and underwriting expenses than in most property and casualty lines. The claims process can be complex, particularly on contract surety claims, and subrogation recovery frequently takes extended periods of time, resulting in medium tail business.

Credit

Our credit business provides insurance policies that insure against the risk of non-payment on trade-related transactions and financings. These policies are provided to manufacturers, banks and trading companies. Coverage is provided on a single debtor or multiple debtor basis, with multi-debtor coverage generally provided on an excess of loss basis. Political risk insurance is also provided. The business is large limit and large premium business. Underwriting includes credit quality analysis of individual transactions, as well as controlling aggregation of limits by debtor and by country. Potential claims are reported promptly. While most policies have a term of two years or less, coverage can be as long as five years. In most claims, there is the possibility of subrogation recoveries, although these can extend over several years. As a result, the business has a medium tail.

International Segment

Our International segment includes energy, property treaty, liability, surety, credit, property (direct and facultative), ocean marine, accident and health and other smaller product lines written from operations in the United Kingdom, Spain and Ireland. A large part of the business is written in London through both our insurance company operations and our Lloyd s syndicate and is primarily received from the major worldwide insurance brokerage companies.

Our energy, ocean marine, property treaty, property and accident and health lines are exposed to natural peril and other catastrophic occurrences. The underwriting process for these lines includes not only evaluation of individual risks but also aggregations of limits by peril by catastrophe area.

Key lines of business within this segment are described below:

Energy

We provide coverage for insureds involved in all areas of energy, ranging from upstream exploration and production, through midstream storage and transmission, to downstream refining and petrochemical activities. Offshore risks include drilling rigs, production and gathering platforms, and pipelines. We underwrite physical damage, liability, business interruption and various ancillary coverages. The business is characterized by large limits and large premiums and includes both primary and excess policies. Claims for this business are reported and settled on a medium-term basis.

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Property Treaty

Our property treaty line provides reinsurance to a variety of clients around the world, offering coverage on a range of products including property catastrophe treaty and property risk and engineering treaty in the U.S. and internationally. Catastrophe excess of loss business is the largest portion of the portfolio. The business is characterized by large limits, large premiums and short to medium-tail claims reporting and settlement.

Liability

Our liability lines primarily include U.K. professional indemnity, employers liability and public liability coverages. Professional indemnity coverages are focused on small and medium size enterprises and cover a range of professions. The employers liability and public liability lines provide coverage on both a primary and excess basis for a range of companies. The business is characterized by small to medium limits and long-tail claims reporting and settlement.

Surety & Credit

Our surety business specializes in performance bonds for construction companies and also writes customs bonds, pension bonds, environment bonds and auctioneer s bonds in the United Kingdom, Ireland, Spain and France. The business is written directly with the client or through insurance brokers. Our credit business is written through the U.K. specialist broker market with a focus on the construction sector. The business is characterized by small to medium limits and short-tail claims reporting and settlement.

Property (Direct and Facultative)

We write direct and facultative property coverage on a following basis, often with catastrophe exposure, for numerous classes including manufacturing, retail, real estate, hotels and municipalities. We provide coverage for both physical damage and business interruption on a worldwide basis to companies ranging in size from small to multinational.

Investing Segment

The Investing segment includes our consolidated investment portfolio, as well as the results from these investments, including investment income, investment related expenses, realized investment gains and losses, and other-than-temporary impairment credit losses on investments. We manage and evaluate our investments centrally as we believe this approach maximizes our investment performance and allows our underwriting segment managers to focus solely on the generation of underwriting results.

Our investment objectives are as follows:

- Preserve and grow our shareholders equity,
- Maximize net investment income on an after-tax basis,
- Maintain appropriate liquidity to satisfy the requirements of current operations and insurance reserve obligations,
- Comply with all applicable regulatory requirements, and
- Effectively hedge the economic exposures of insurance liabilities in their functional currency.

For additional discussion about the composition and results of our Investing Segment, see Investing Segment included in Management s Discussion and Analysis and Note 2, Investments to the Consolidated Financial Statements.

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Enterprise Risk Management

Our Enterprise Risk Management (ERM) process provides us with a structured approach to identify, manage, report and respond to downside risks or threats, as well as business opportunities. This process enables us to assess risks in a more consistent and transparent manner, resulting in improved recognition, management and monitoring of risk. The key objectives of our ERM process are to support our decision making and to promote a culture of risk awareness throughout the company, thereby allowing us to preserve shareholders equity and grow book value.

Our ERM initiative is supported by the Enterprise Risk Oversight Committee of our Board of Directors. Our internal risk management functions are led by a corporate Senior Vice President of our Enterprise Risk Management Department, who reports to the Chief Executive Officer. In addition, an internal Risk Committee, comprised of our senior executives, reports to the Chief Executive Officer and assists the Board in identifying and assessing risks.

We use a variety of methods and tools company-wide in our risk assessment and management efforts. Our key methods and tools include: 1) underwriting risk management, where underwriting authority limits are set, 2) natural catastrophic risk management, where a variety of catastrophe modeling techniques, both internal and external, are used to monitor loss exposures, 3) a Reinsurance Security Policy Committee, which is responsible for monitoring reinsurers, reinsurance recoverable balances and changes in a reinsurer s financial condition, 4) investment risk management, where the Investment and Finance Committee of our Board of Directors provides oversight of our capital and financial resources, and our investment policies, strategies, transactions and investment performance, 5) the use of our economic capital model, which we integrate into our planning, 6) the use of outside experts to perform scenario testing, where deemed beneficial and 7) a risk reporting framework, including a risk dashboard, to regularly communicate to management and the Board our risk profile related to our risk appetite and tolerances. We plan to continue to invest in resources and technology to support our ERM process.

Reserves for Insurance Claims

We underwrite insurance risks and establish actual and estimated reserves for insurance claims under the policies we have written. Our gross reserves for insurance claims, shown as loss and loss adjustment expense payable on our consolidated balance sheet, consist of reserves for reported claims (referred to herein as case reserves) and reserves for incurred but not reported losses (referred to herein as IBNR). Our IBNR reserves also cover potential movement in claims already reported. Our net reserves reflect the offset of reinsurance recoverables due to us from third party reinsurers, based upon the contractual terms of our reinsurance agreements. In the normal course of our business, we cede a portion of our premium to domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although reinsurance does not discharge us from liability to our policyholders, we participate in reinsurance agreements to limit our loss exposure and to protect us against catastrophic losses.

Our recorded reserves represent management s best estimate of unpaid losses and loss adjustment expenses as of each quarter end. The process of estimating our reserves is inherently uncertain and involves a considerable degree of judgment involving our management review and actuarial processes. Because we provide insurance coverage in specialized lines of business that often lack statistical stability, management considers many factors in determining ultimate losses and reserves. These factors include: 1) actuarial point estimates and the estimated ranges around these estimates, 2) information used to price the applicable policies, 3) historical loss information, where available, 4) public industry data for the product or similar products, 5) an assessment of current market conditions, 6) information on individual claims, 7) an assessment of current or potential litigation involving claims and 8) information from underwriting and claims personnel. The estimate of our reserves is increased or decreased as more information becomes known about the frequency and severity of losses for individual years. We believe our review process is effective, such that any required changes in reserves are recognized in the period of change as soon as the need for the change is evident.

Loss development represents an increase or decrease in estimates of ultimate losses related to business written in prior accident years. A redundancy, also referred to as favorable development, means the original ultimate loss estimate was higher than the current estimate. A deficiency, or adverse development, means the current ultimate loss estimate is higher than the original estimate. A loss development triangle details the subsequent years changes in loss estimates from prior loss estimates, based on experience at the end of each succeeding year.

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The table below shows development of our reserves from 2002 through 2012, as of December 31, 2012. The first line shows our net reserves, including reserves for IBNR, recorded on our consolidated balance sheet at the indicated year end. The first section of the table shows, by year, the cumulative amount of net losses and loss adjustment expenses paid at the end of each succeeding year. The second section shows the re-estimated net reserves in later years for the years indicated. The cumulative redundancy (deficiency) line represents the difference between the latest re-estimated net reserves and the originally estimated net reserves. The bottom section of the table shows our gross reserves and reinsurance recoverables, as well as their re-estimated amounts at the indicated year end.

(in thousands)	**2012**	**2011**	**2010**	**2009**	**2008**	**2007**	**2006**	**2005**	**2004**	**2003**	**2002**
Reserves, net of reinsurance	$ 2,749,803	$ 2,683,483	$ 2,537,772	$ 2,555,840	$ 2,416,271	$ 2,342,800	$ 2,108,961	$ 1,533,433	$ 1,059,283	$ 705,200	$ 458,702
Reserve adjustments*	-	14,705	20,969	32,569	59,303	70,242	46,761	21,997	6,613	-	5,587
Adjusted reserves, net of reinsurance	2,749,803	2,698,188	2,558,741	2,588,409	2,475,574	2,413,042	2,155,722	1,555,430	1,065,896	705,200	464,289
Cumulative paid, net of reinsurance, at:											
One year later		729,335	726,445	763,140	618,699	687,675	556,096	222,336	172,224	141,677	115,669
Two years later			1,114,541	1,144,929	1,001,369	940,636	858,586	420,816	195,663	135,623	152,674
Three years later				1,432,617	1,263,091	1,177,900	1,013,122	588,659	337,330	124,522	115,214
Four years later					1,408,275	1,331,379	1,176,404	702,072	424,308	217,827	88,998
Five years later						1,392,797	1,299,663	822,133	495,642	313,315	155,708
Six years later							1,375,431	927,657	581,418	376,903	242,904
Seven years later								988,152	661,517	442,736	301,828
Eight years later									701,979	498,399	351,404
Nine years later										542,138	378,363
Ten years later											435,652
Re-estimated liability, net of reinsurance, at:											
End of year	2,749,803	2,698,188	2,558,741	2,588,409	2,475,574	2,413,042	2,155,722	1,555,430	1,065,896	705,200	464,289
One year later		2,628,177	2,568,888	2,565,746	2,422,050	2,330,671	2,129,325	1,548,904	1,091,290	735,678	487,403
Two years later			2,506,803	2,525,266	2,367,979	2,241,422	2,018,898	1,522,411	1,090,568	770,497	500,897
Three years later				2,482,192	2,292,210	2,184,222	1,919,507	1,434,327	1,084,585	792,099	571,403
Four years later					2,254,239	2,107,876	1,887,146	1,364,822	1,043,778	808,261	585,741
Five years later						2,017,782	1,825,976	1,342,769	1,019,071	794,740	613,406
Six years later							1,797,913	1,292,149	1,019,322	792,896	597,666
Seven years later								1,316,416	983,932	783,442	602,546
Eight years later									1,003,117	782,921	600,667
Nine years later										798,702	621,719
Ten years later											641,481
Cumulative redundancy (deficiency), net of reinsurance		$ 70,011	$ 51,938	$ 106,217	$ 221,335	$ 395,260	$ 357,809	$ 239,014	$ 62,779	($ 93,502)	($ 177,192)
Gross reserves, end of year*	$ 3,767,850	$ 3,678,271	$ 3,497,954	$ 3,528,628	$ 3,484,886	$ 3,309,621	$ 3,150,213	$ 2,838,231	$ 2,096,940	$ 1,525,313	$ 1,164,502
Reinsurance recoverables*	1,018,047	980,083	939,213	940,219	1,009,312	896,579	994,491	1,282,801	1,031,044	820,113	700,213

Net reserves, end of year*	$ 2,749,803	$ 2,698,188	$ 2,558,741	$ 2,588,409	$ 2,475,574	$ 2,413,042	$ 2,155,722	$ 1,555,430	$ 1,065,896	$ 705,200	$ 464,289
Re-estimated gross reserves	$ 3,767,850	$ 3,638,963	$ 3,486,365	$ 3,471,047	$ 3,277,254	$ 2,886,779	$ 2,658,548	$ 2,462,132	$ 1,947,565	$ 1,639,156	$ 1,520,858
Re-estimated reinsurance recoverables	1,018,047	1,010,786	979,562	988,855	1,023,015	868,997	860,635	1,145,716	944,448	840,454	879,377
Re-estimated net reserves	$ 2,749,803	$ 2,628,177	$ 2,506,803	$ 2,482,192	$ 2,254,239	$ 2,017,782	$ 1,797,913	$ 1,316,416	$ 1,003,117	$ 798,702	$ 641,481
Cumulative gross redundancy (deficiency)		$ 39,308	$ 11,589	$ 57,581	$ 207,632	$ 422,842	$ 491,665	$ 376,099	$ 149,375	($ 113,843)	($ 356,356)

* Adjusted for acquisitions and dispositions.

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The redundancies for 2004 through 2011 reflected in the above table were recorded as favorable development in the years shown in the following table (in thousands):

	Gross	Net
2012	$ 39,308	$ 70,011
2011 (excluding diversified financial products)	158,797	94,010
2010	16,352	22,663
2009	90,435	53,524
2008	72,044	82,371
2007	90,621	26,397

The majority of this favorable development related to these products: 1) D&O in our Professional Liability segment, for the 2002 2006 underwriting years, 2) U.K. professional liability, energy and property (including redundancy on the 2005, 2008 and 2011 catastrophe losses) in our International segment, 3) surety in our U.S. Surety & Credit segment and 4) an assumed quota share program that we wrote from 2003 to 2008 in our U.S. Property & Casualty segment.

During 2011, we increased our reserves for the diversified financial products line of business, more than offsetting the favorable development on other lines of business for that year. This increase primarily affected the 2010 and 2009 accident years. See Segment Operations Professional Liability Segment included in Management s Discussion and Analysis for additional discussion.

The deficiencies for 2002 and 2003 reflected in the table resulted primarily from run-off assumed accident and health reinsurance business in our Exited Lines, recorded in the years shown in the following table (in thousands):

	Gross	Net
2006	$ 15,054	$ 25,097
2005	49,775	34,970
2004	127,707	27,326
2003	132,924	28,751

This accident and health business is primarily excess coverage for large losses related to workers compensation policies. The deficiencies affected the 2001 and prior accident years and were recorded due to our receipt of additional information and our continuing evaluation of reserves on this business. Losses tend to develop and affect excess covers considerably later than the original loss was incurred, which causes late reporting to us. Additionally, certain primary insurance companies that we reinsured experienced financial difficulties and were liquidated, leaving guaranty funds responsible for administering the business. While we have attempted to anticipate these conditions, there remains uncertainty in estimating these reserves, and there could be additional development of these reserves in the future.

A large proportion of the net deficiencies on the accident and health business resulted from reinsurance commutations totaling $20.2 million in 2006, $26.0 million in 2005 and $28.8 million in 2003 related to our Exited Lines. Commutations can produce adverse prior year development since, under generally accepted accounting principles, any excess of undiscounted reserves assumed over assets received must be recorded as a loss at the time the commutation is completed. Economically, the loss generally represents the discount for the time value of money that will be earned over the payout period of the reserves. Thus, the loss may be recouped as investment income is earned on the assets received.

For additional discussion of our reserve processes and the changes in our loss and loss adjustment expense for 2012, 2011 and 2010, see Critical Accounting Policies Reserves included in Management s Discussion and Analysis.

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Regulation

The business of insurance is extensively regulated by the government. Our business depends on our compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Generally, regulatory authorities are vested with broad discretion to grant, renew and revoke licenses and approvals and to implement regulations governing the business and operations of insurers, insurance agents, brokers and third party administrators. In all jurisdictions, the applicable laws and regulations are subject to amendment or interpretation by regulatory authorities.

United States

State Governments

At this time, the insurance business in the United States is regulated primarily by the individual states. Although the extent of the regulation varies, it relates to, among other things: 1) standards of solvency that must be met and maintained, 2) licensing of insurers and their agents, 3) approval of policy forms, 4) restrictions on the size of risks that may be insured under a single policy, 5) regulation of market conduct, as well as other underwriting claim practices, 6) premium rates, 7) reserves and provisions for unearned premium, losses and other obligations, 8) the nature of and limitations on investments and 9) usage of certain methods of accounting for statutory reporting purposes.

State insurance regulations are intended primarily for the protection of policyholders rather than shareholders. The state insurance departments monitor compliance with regulations through periodic reporting procedures and examinations. The quarterly and annual financial reports to the state insurance regulators utilize statutory accounting principles, which are different from generally accepted accounting principles (GAAP) that we use in our reports to shareholders. Statutory accounting principles, in keeping with the intent to assure the protection of policyholders, are generally based on a solvency concept, while GAAP is based on a going-concern concept.

The state insurance regulators utilize risk-based capital measurements, developed by the National Association of Insurance Commissioners (NAIC), to identify insurance companies that potentially are inadequately capitalized. The NAIC s risk-based capital model is intended to establish minimum capital thresholds that vary with the size and mix of an insurance company s business and assets. It is designed to identify companies with capital levels that may require regulatory attention. At December 31, 2012, each of our domestic insurance companies total adjusted capital was significantly in excess of the authorized control level risk-based capital.

In September 2012, the NAIC adopted the Risk Management and Own Risk and Solvency Assessment (ORSA) model act which, following enactment at the state level, will be effective in 2015. ORSA requires U.S. insurance companies and their group to maintain an ERM framework, perform an annual internal assessment of risk associated with the insurer s business plan, and assess the sufficiency of capital required to support the plan. While we have an effective ERM framework, we are currently unable to predict the full impact of complying with ORSA.

The U.S. state insurance regulations also affect the payment of dividends and other distributions by insurance companies to their shareholders. Generally, insurance companies are limited by these regulations in the payment of dividends above a specified level. Dividends in excess of those thresholds are extraordinary dividends and are subject to prior regulatory approval. Some states require prior regulatory approval for all dividends.

Because we are an insurance holding company, we are subject to the insurance holding company system regulatory requirements of a number of states. Under these regulations, we are required to report information regarding our capital structure, financial condition and management. We are also required to provide prior notice to, or seek the prior approval of, insurance regulatory authorities of certain agreements and transactions between our affiliated companies. These agreements and transactions must satisfy certain regulatory requirements.

Federal Government

Although the U.S. Federal government has not historically regulated the insurance industry, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), enacted in July 2010, expands the federal presence in insurance oversight. The Dodd-Frank Act s requirements include streamlining the state-based regulation of reinsurance and non-admitted insurance. The Dodd-Frank Act also established the Federal Insurance Office (FIO) within the U.S. Department of the Treasury with powers over all lines of insurance except health insurance, certain long-term care insurance and crop insurance, and the Financial Stability Oversight Council (FSOC).

The FIO is authorized to gather data and information to monitor aspects of the insurance industry, identify issues in the regulation of insurers about insurance matters, and preempt state insurance measures under certain circumstances. The FIO may also recommend enhanced regulations to state regulatory authorities or recommend to the FSOC that it designate an insurer as a systematically important financial institution (SIFI). An insurer designated as an SIFI could be subject to Federal Reserve supervision and heightened regulatory standards. While we do not believe that HCC or any of its companies qualify as an SIFI, it is possible the FSOC could conclude otherwise.

United Kingdom and Spain

In the United Kingdom, the Financial Services Authority (FSA) supervises all securities, banking and insurance businesses, including Lloyd s of London (Lloyd s). The FSA oversees compliance with: 1) established periodic auditing and reporting requirements, 2) risk assessment reviews, 3) minimum solvency margins, 4) dividend restrictions, 5) restrictions governing the appointment of key officers, 6) restrictions governing controlling ownership interests and 7) various other requirements.

We maintain 100% participation in Lloyd s Syndicate 4141. Under our membership agreement with Lloyd s, we must comply with all Lloyd s by-laws and regulations, as well as applicable provisions of the Lloyd s Acts and Financial Services and Markets Act 2000. Our underwriting capacity in Syndicate 4141 must be supported by providing a deposit (referred to as Funds at Lloyd s) of cash, securities or letters of credit, which is determined annually by Lloyd s. Lloyd s requires annual approval of Syndicate 4141 s business plan, including maximum underwriting capacity, and may require changes to any business plan or additional capital to support the underwriting capacity. If a member of Lloyd s is unable to pay its debts to policyholders, such debts may be payable by Lloyd s Central Fund. Lloyd s has the power to assess current Lloyd s members up to 3% of the member s underwriting capacity in any one year as a Central Fund contribution.

In Spain, the primary regulator of our insurance operations is the Spanish General Directorate of Insurance and Pension Funds of the Ministry of the Economy and Treasury (Dirección General de Seguros y Fondos de Pensiones del Ministerio de Economía y Hacienda) (DGS). The DGS oversees compliance with periodic reporting requirements, risk and reserves assessment, and various other requirements.

In the U.K. and Spain, our insurance companies will be required to meet the requirements of the European Union s (EU) new financial services regulatory regime known as Solvency II, which is built on a risk-based approach to setting capital requirements for insurers. Solvency II establishes a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements. Solvency II is expected to be implemented no earlier than 2015, and we will be required to meet its requirements. We have made significant progress in meeting the requirements in our U.K. companies. However, a broader impact to us will depend on whether the U.S. insurance regulatory regime is deemed equivalent to Solvency II; if not, we could be supervised under Solvency II standards. Whether the U.S. insurance regulatory regime will be deemed equivalent is still under consideration by EU authorities, so we are currently unable to predict the full impact of Solvency II.

The Financial Stability Board (FSB), consisting of representatives of national financial authorities of the G20 nations, has issued a series of frameworks and recommendations intended to produce significant changes in how financial companies should be regulated. These frameworks and recommendations address such issues as financial group supervision, capital and solvency standards, systemic economic risk, corporate governance including compensation, and related issues associated with responses to the financial crisis. The FSB has directed the International Association of Insurance Supervisors (IAIS) to create standards relative to these areas and incorporate them in that body s Insurance Core Principles, which form the baseline for how countries financial services regulatory efforts are measured relative to the insurance sector. That measurement is made by periodic Financial Sector Assessment Program (FSAP) reviews conducted by the World Bank and the International Monetary Fund, and the reports thereon spur development of country-specific additional or amended regulatory changes. Lawmakers and regulatory authorities in a number of jurisdictions in which our companies conduct business have already begun implementing legislative and regulatory changes consistent with these recommendations.

Insurance Companies

The following is a list of our insurance companies that are subject to regulation:

United States

American Contractors Indemnity Company
Avemco Insurance Company
HCC Life Insurance Company
HCC Specialty Insurance Company
Houston Casualty Company
Perico Life Insurance Company
United States Surety Company
U.S. Specialty Insurance Company

United Kingdom

HCC International Insurance Company
Houston Casualty Company-London
Lloyd s of London Syndicate 4141

Spain

Houston Casualty Company Europe, Seguros y Reaseguros, S.A.

Bermuda

HCC Reinsurance Company Limited

Agencies

The jurisdictions in which each of our underwriting agencies operate impose licensing and other requirements. These regulations relate primarily to: 1) licensing as agents, brokers, reinsurance brokers, managing general agents or third party administrators, 2) advertising and business practice rules, 3) contractual requirements, 4) limitations on authority, 5) financial security and 6) record keeping requirements.

The following is a list of our underwriting agencies that are subject to regulation:

HCC Global Financial Products
HCC Indemnity Guaranty Agency
HCC Medical Insurance Services
HCC Specialty
HCC Underwriting Agency

Terrorism Risk Insurance Act

The Federal Terrorism Risk Insurance Act (TRIA) was initially enacted in 2002 to ensure the availability of insurance coverage for certain acts of terrorism, as defined in the TRIA. The Terrorism Risk Insurance Program Reauthorization Act of 2007 (Reauthorization Act) extended the program through December 31, 2014. The Reauthorization Act revised the definition of Act of Terrorism to remove the requirement that the act of terrorism be committed by an individual acting on behalf of any foreign person or foreign interest in order to be certified under the Reauthorization Act. The Reauthorization Act requires a $100.0 million loss event to trigger coverage. The Federal government will reimburse 85% of an insurer s losses in excess of the insurer s deductible, up to the maximum annual Federal liability of $100.0 billion.

Under the Reauthorization Act, we are required to offer terrorism coverage to our commercial policyholders in certain lines of business, for which we may, when warranted, charge an additional premium. The policyholders may or may not accept such coverage. Our deductible for 2013 is approximately $136.5 million, which we would have to meet before the Federal reimbursement would occur.

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Executive Officers

The following is a list of our Executive Officers:

Name	Principal occupation during past five years	Age	Served HCC since
William N. Burke, Jr.	Mr. Burke has served as our President and Chief Operating Officer since December 2012. He previously served as our Executive Vice President and Chief Operating Officer from March 2012 until December 2012. Prior to joining HCC, Mr. Burke served as Chief Operating Officer for Aon Risk Solutions US Retail. He commenced his insurance career in 1977 with the Home Insurance Company and has most recently been with Aon Corporation and its successor company for almost 30 years.	57	2012
Mark W. Callahan	Mr. Callahan has served as our Executive Vice President and Chief Underwriting Officer since March 2011. He previously served as our Executive Vice President and Chief Actuary from August 2010 to March 2011. Prior to joining HCC, Mr. Callahan served as the Chief Risk, Underwriting, and Actuarial Services Officer for XL Insurance. During 12 years there, he also held the positions of Senior Vice President and Underwriter for XL Financial Solutions and Executive Vice President and Chief Actuarial Officer for XL Insurance.	42	2010
Barry J. Cook	Mr. Cook has served as our Executive Vice President of International Operations and Chief Executive Officer of HCC Insurance Holdings (International) Limited, with oversight for our international operations, since 2006. From 1992 to 2005, Mr. Cook served as Chief Executive Officer of Rattner Mackenzie Limited, which we acquired in 1999.	52	1999
Brad T. Irick	Mr. Irick has served as our Executive Vice President since May 2010 and our Chief Financial Officer since August 2010. Prior to joining HCC, Mr. Irick was with PricewaterhouseCoopers LLC for 18 years, where he served as audit and advisory partner for several multinational public insurance company clients, including HCC between 2004 and the first half of 2007. Mr. Irick is a Certified Public Accountant.	46	2010
Craig J. Kelbel	Mr. Kelbel has served as our Executive Vice President of Accident & Health Operations since 2002 and President and Chief Executive Officer of HCC Life Insurance Company since 2005. Prior to joining HCC, Mr. Kelbel was the President of USBenefits Insurance Services, Inc. and Vice President of its parent company, The Centris Group, Inc., which HCC acquired in 1999. Mr. Kelbel has over 35 years of experience in the insurance industry.	58	1999
Pamela J. Penny	Ms. Penny has served as our Executive Vice President and Chief Accounting Officer since 2008. She previously served as Senior Vice President Finance from 2004 to November 2008. Prior to joining HCC, Ms. Penny served in varying capacities with Aegis Mortgage Corporation from 2003 to 2004 and American International Group, Inc. (formerly American General Corporation), including Senior Vice President & Controller of American General, from 1991 to 2003. Prior to that time, she was a partner in the international accounting firm KPMG LLP. Ms. Penny is a Certified Public Accountant.	58	2004

Name	Principal occupation during past five years	Age	Served HCC since
Randy D. Rinicella	Mr. Rinicella has served as our Senior Vice President, General Counsel and Secretary since 2007. Prior to joining HCC, Mr. Rinicella was Vice President, General Counsel and Secretary of Dresser-Rand Group, Inc., a publicly-traded equipment supplier to the worldwide oil, gas, petrochemical and process industries, from 2005 until 2007. Mr. Rinicella was a shareholder at the national law firm of Buchanan Ingersoll PC from 2004 until 2005, where he was a member of the firm s corporate finance & technology practice group.	55	2007
Michael J. Schell	Mr. Schell has served as our Executive Vice President since 2002. In addition, since 2010, Mr. Schell has served as our Chief Property and Casualty Insurance Officer, with oversight for our property and casualty operations. From 2007 to 2010, Mr. Schell served as our Chief Underwriting Officer. Prior to joining HCC in 2002, Mr. Schell was with the St. Paul Companies for 25 years, most recently as President and Chief Operating Officer of St. Paul Re.	62	2002
Christopher J.B. Williams	Mr. Williams has served as our Chief Executive Officer since December 2012 and as a member of our Board of Directors since May 2007, including as Chairman of the Board from August 2008 to May 2011. He previously served as our President from May 2011 to December 2012. Before joining HCC, Mr. Williams was Chairman of Wattle Creek Winery from 2005 to May 2011. Prior to his retirement in 2005, he served as the National Director for Life, Accident & Health of Willis Re. Mr. Williams currently serves as a member of the Investment and Finance Committee and the Enterprise Risk Oversight Committee of our Board.	56	2011

Employees

At December 31, 2012, we had 1,870 employees. We are not a party to any collective bargaining agreement and have not experienced work stoppages or strikes as a result of labor disputes. We consider our employee relations to be good.

Available Information

The public may read and copy any materials that we file with the Securities and Exchange Commission (SEC) at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site (*www.sec.gov*) that contains financial reports, proxy statements and other information that we file electronically with the SEC.

We maintain an Internet website at *www.hcc.com.* The reference to our Internet website address in this Report does not constitute the incorporation by reference of the information contained at the website in this Report. We will make available, free of charge through publication on our Internet website, a copy of our Annual Report on Form 10-K and Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K or amendments to those reports, filed with or furnished to the SEC.

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Item 1A. ***Risk Factors***

Risks Relating to our Industry

Because we are a property and casualty insurer, our business may suffer as a result of unforeseen catastrophe losses.

Property and casualty insurers are subject to claims arising from catastrophes. Catastrophic losses have had a significant impact on our historical results. Catastrophes can be caused by various events, including hurricanes, tsunamis, tornados, windstorms, earthquakes, hailstorms, explosions, flooding, severe winter weather and fires and may include man-made events, such as terrorist attacks and systemic risks. The incidence, frequency and severity of catastrophes are inherently unpredictable. Some scientists believe that in recent years, changing climate conditions have added to the unpredictability and frequency of natural disasters.

The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Insurance companies are not permitted to reserve for a catastrophe until it has occurred. Catastrophes can cause losses in a variety of our property and casualty lines, and most of our past catastrophe-related claims have resulted from hurricanes and earthquakes; however, we experienced significant losses from the 2001 terrorist attack in the U.S. and the 2011 tsunami in Japan. A large part of our exposure to catastrophes comes from our International segment, particularly related to our property, property treaty and energy businesses.

Although we typically purchase reinsurance protection for risks we believe bear a significant level of catastrophe exposure, the nature or magnitude of losses attributed to a catastrophic event or events may result in losses that exceed our reinsurance protection. It is therefore possible that a catastrophic event or multiple catastrophic events could have a material adverse effect on our financial position, results of operations and liquidity.

The insurance and reinsurance business is historically cyclical, and we expect to experience periods with excess underwriting capacity and unfavorable premium rates, which could cause our results to fluctuate.

The insurance and reinsurance business historically has been a cyclical industry characterized by periods of intense price competition due to excessive underwriting capacity, as well as periods when shortages of capacity permitted an increase in pricing and, thus, more favorable premium levels. An increase in premium levels is often, over time, offset by an increasing supply of insurance and reinsurance capacity, either from capital provided by new entrants or by additional capital committed by existing insurers or reinsurers, which may cause prices to decrease. In addition, changes in the frequency and severity of losses suffered by insureds and insurers may affect the cycles of the insurance and reinsurance business significantly.

Any of these factors could lead to a significant reduction in premium rates, less favorable policy terms and fewer opportunities to underwrite insurance risks, which could have a material adverse effect on our results of operations and cash flows. These factors may also cause the price of our common stock to be volatile.

Our loss reserves are based on an estimate of our future liability, which may prove to be inadequate.

We maintain loss reserves to cover our estimated liability for unpaid losses and loss adjustment expenses, including legal and other fees, for reported and unreported claims incurred at the end of each accounting period. Reserves do not represent an exact calculation of liability. Rather, reserves represent an estimate of what we expect the ultimate settlement and administration of claims will cost. These estimates are based on our assessment of facts and circumstances then known, as well as estimates of future trends in severity of claims, frequency of claims, judicial theories of liability and other factors. These variables are affected by both internal and external events that could increase our exposure to losses, including changes in actuarial projections, claims handling procedures, inflation, climate change, economic and judicial trends, and legislative changes.

Volatility in the financial markets, economic events, legal/regulatory changes and other external factors may result in an increase in the number of claims and the severity of the claims reported, particularly in lines of business such as directors and officers liability, errors and omissions liability and trade credit insurance. Many of these items are not directly quantifiable in advance. Additionally, there may be a significant reporting delay between the occurrence of the insured event and the time it is reported to us.

The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to our loss and loss adjustment expenses are reflected in our results of operations in the periods in which such estimates are changed. Because setting reserves is inherently uncertain, there can be no assurance that current reserves will prove adequate in light of subsequent events. If actual claims prove to be greater than our reserves, our financial position, results of operations and liquidity may be materially adversely affected.

We may be impacted by claims relating to economic or credit market downturns.

We write corporate directors and officers liability, errors and omissions liability and other insurance coverages for financial institutions and financial services companies. We also write trade credit business for policyholders who have credit and political risk, as well as policies in certain countries that have had adverse economic conditions. The volatility in the economy and the financial markets in the past several years has had an impact on this part of the industry. As a result, this part of the industry has been the subject of heightened scrutiny and, in some cases, investigations by regulators with respect to the industry s actions. These events may give rise to increased claims litigation, including class action suits, which may involve our insureds. To the extent that the frequency or severity of claims relating to these events exceeds our current estimates used for establishing reserves, it could increase our exposure to losses from such claims and could have a material adverse effect on our financial position and results of operations.

The effects of emerging claim and coverage issues on our business are uncertain.

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended liability for claims and coverage may emerge. These changing conditions may adversely affect our business by either extending coverage beyond our underwriting intent or by increasing the number or size of claims. In some instances, these changes may not become apparent until some time after we have issued insurance or reinsurance contracts that are affected by the changes. As a result, the full extent of liability under our insurance or reinsurance contracts may not be known for many years after a contract is issued, and our financial position and results of operations may be materially adversely affected.

We are subject to extensive governmental regulation.

We are subject to extensive governmental regulation and supervision. For complete information regarding the regulations to which we are subject, see Item 1, Business Regulation. Our business depends on compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Most insurance regulations are designed to protect the interests of policyholders rather than shareholders and other investors. In the United States, this regulation is generally administered by departments of insurance in each state in which we do business and includes a comprehensive framework of oversight of our operations and review of our financial position. U.S. Federal legislation may lead to additional federal regulation of the insurance industry in the coming years. Also, foreign governments regulate our international operations. Each foreign jurisdiction has its own unique regulatory framework that applies to our operations in that jurisdiction.

Regulatory authorities have broad discretion to grant, renew or revoke licenses and approvals. Regulatory authorities may deny or revoke licenses for various reasons, including the violation of regulations. In some instances, we follow practices

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based on our interpretations of regulations, or those we believe to be generally followed by the industry, which ultimately may be different from the requirements or interpretations of regulatory authorities. If we do not have the requisite licenses and approvals and do not comply with applicable regulatory requirements, the insurance regulatory authorities could preclude or temporarily suspend us from carrying on some or all of our activities or otherwise penalize us. That type of action could have a material adverse effect on our results of operations. Also, changes in the level of regulation of the insurance industry (whether federal, state or foreign), or changes in laws or regulations themselves or interpretations by regulatory authorities, could have a material adverse effect on our business.

Virtually all states require insurers licensed to do business in that state to bear a portion of the loss suffered by some insureds as the result of impaired or insolvent insurance companies or to bear a portion of the cost of insurance for high-risk or uninsured individuals. Depending on state law, insurers can be assessed 1% to 2% of premium written for the relevant line of insurance in that state. In addition, states have from time to time passed legislation that has the effect of limiting the ability of insurers to manage catastrophe risk, such as legislation limiting insurers ability to increase rates and prohibiting insurers from withdrawing from catastrophe-exposed areas. The effect of these arrangements could materially adversely affect our results of operations.

The Dodd-Frank Act expands the U.S. Federal government s presence in insurance oversight, streamlines state-based regulation of reinsurance and non-admitted insurance and establishes a new Federal Insurance Office with powers over most lines of insurance other than health insurance. The Federal Insurance Office is authorized to gather data and information to monitor aspects of the insurance industry, identify issues in the regulation of insurers about insurance matters, and preempt state insurance measures under certain circumstances. As the Dodd-Frank Act calls for numerous studies and contemplates further regulation, its future impact on our results of operations or financial position cannot be determined at this time.

The European Union (EU) is phasing in a new regulatory regime for the regulation of financial services known as Solvency II, which is built on a risk-based approach to setting capital requirements for insurers and reinsurers. Solvency II is expected to be implemented no earlier than 2015. The impact on us from our implementation of Solvency II will depend on the costs associated with implementation by each EU country, any increased capital requirements applicable to us, and any costs associated with adjustments to our operations. In addition, the overall impact will depend on whether the U.S. regulatory regime is deemed equivalent to Solvency II, thereby reducing the costs of implementation. As such, we are currently not able to predict the impact of Solvency II on our financial position and results of operations.

The operations of certain of our subsidiaries are subject to laws and regulations, including the USA PATRIOT Act of 2001, which requires companies to know certain information about their clients and to monitor their transactions for suspicious activities. In addition, the Department of the Treasury s Office of Foreign Assets Control administers regulations requiring U.S. persons to refrain from doing business, or allowing their clients to do business through them, with certain organizations or individuals on a prohibited list maintained by the U.S. government or with certain countries. The United Kingdom, the European Union and other jurisdictions maintain similar laws and regulations. Although we have instituted compliance programs to address these requirements, our participation in the global market could expose us to penalties under these laws.

We participate in the Lloyd s of London market through 100% participation in Lloyd s Syndicate 4141. The Lloyd s Franchise Board requires annual approval of Syndicate 4141 s business plan, including maximum underwriting capacity, and may require changes to our business plan or additional capital to support our underwriting. Lloyd s also imposes various charges and assessments on its member companies. If Lloyd s were to require material changes in our business plans, or if charges and assessments payable by us to Lloyd s were to increase significantly, these events could have an adverse effect on our operations and financial results. In addition, no assurances can be given as to how much business Lloyd s will permit us to underwrite in the future. The financial security of the Lloyd s market is regularly assessed by three independent rating agencies. A satisfactory credit rating issued by an accredited rating agency is necessary for Lloyd s syndicates to be able to trade in certain classes of business at current levels. We would be adversely affected if Lloyd s current ratings were downgraded.

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Recent federal health care reform legislation may lead to changes in the country s health care delivery system.

The Patient Protection and Affordable Care Act and the related amendments in the Health Care and Education Reconciliation Act (collectively, the Legislation), enacted in 2010, may lead to changes in the U.S. health care delivery system. As a result of the Legislation, there may be numerous changes in the health care industry, including an increasing percentage of the population that is covered for health care costs. Currently, we do not believe the Legislation will have a material adverse effect on our business. However, as the Legislation contemplates further regulation, we are unable to assess with certainty the full impact the Legislation may have on our business.

We cannot predict the effect, if any, climate change may have on the risks we insure.

Various scientists, environmentalists, international organizations and regulators believe that global climate change has added, and will continue to add, to the unpredictability, frequency and severity of natural disasters (including, but not limited to, hurricanes, tornados, freezes, other storms and fires) in certain parts of the world. In response to this belief, a number of legal and regulatory measures as well as social initiatives have been introduced in an effort to reduce greenhouse gas and other carbon emissions, which may be chief contributors to global climate change. We cannot predict the impact that changing climate conditions, if any, will have on our results of operations or financial condition. Moreover, we cannot predict how legal, regulatory and social responses to concerns about global climate change will impact our business. To the extent climate change does increase the unpredictability, frequency or severity of natural disasters, we may face increased claims, which could have a material adverse effect on our financial position, results of operations and cash flows.

Our reliance on brokers subjects us to risk.

In many cases, we market our insurance (and reinsurance) through insurance (and reinsurance) brokers. Some of these brokers provide a significant portion of our gross written premium for a particular line of business. As a result, some of these brokers could demand higher payments that could put us at a competitive disadvantage and affect the way we price our products. The deterioration of our relationship with, or loss of all or a substantial portion of the business provided by, one or more brokers could have a material adverse effect on our financial position, results of operations and cash flows.

In accordance with industry practice, we generally pay amounts owed on claims under our insurance and reinsurance contracts to brokers, and these brokers, in turn, pay these amounts to the clients that have purchased insurance or reinsurance from us. Although the law is unsettled and depends upon the facts and circumstances of the particular case, in some jurisdictions, if a broker fails to make such a payment, we may remain liable to the insured or ceding insurer for the deficiency. Conversely, in certain jurisdictions, when the insured or ceding insurer pays premiums for these policies to brokers for payment over to us, these premiums might be considered to have been paid and the insured or ceding insurer will no longer be liable to us for those amounts, whether or not we have actually received the premiums from the broker. Consequently, we assume a degree of credit risk associated with brokers with whom we transact business. However, due to the unsettled and fact-specific nature of the law, we are unable to quantify our exposure to this risk.

Consolidation in the insurance industry could adversely impact us.

Insurance industry participants may seek to consolidate through mergers and acquisitions. Continued consolidation within the insurance industry will further enhance the already competitive underwriting environment as we would likely experience more robust competition from larger competitors. These consolidated entities may use their enhanced market power and broader capital base to take business from us or to drive down pricing, which could adversely affect the results of our operations.

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Risks Relating to our Business

Our inability to accurately assess underwriting risk could reduce our net earnings.

Our underwriting success is dependent on our ability to accurately assess the risks associated with the business on which the risk is retained. We rely on the experience of our underwriting staff in assessing these risks. If we fail to accurately assess the risks we retain, we may fail to establish appropriate premium rates and our reserves may be inadequate to cover our losses, which could reduce our net earnings. The underwriting process is further complicated by our exposure to unpredictable developments, including earthquakes, weather-related events and other natural catastrophes, as well as war and acts of terrorism and those that may result from volatility in the financial markets, the economic downturn and systemic risks.

Retentions in various lines of business expose us to potential losses.

We retain risk for our own account on business underwritten by our insurance companies. The determination to not purchase reinsurance, or to reduce the amount of reinsurance we purchase, for a particular risk or line of business is based on a variety of factors including market conditions, pricing, availability of reinsurance, the level of our capital and our loss history. Such determinations have the effect of increasing our financial exposure to losses associated with such risks or in such lines of business and, in the event of significant losses associated with such risks or lines of business, could have a material adverse effect on our financial position, results of operations and cash flows.

If we are unable to purchase adequate reinsurance protection for some of the risks we have underwritten, we will be exposed to any resulting unreinsured losses.

We purchase reinsurance for a portion of the risks underwritten by our insurance companies, especially volatile and catastrophe-exposed risks. Market conditions beyond our control determine the availability and cost of the reinsurance protection we purchase. In addition, the historical results of reinsurance programs and the availability of capital also affect the availability of reinsurance. Our reinsurance facilities are generally subject to annual renewal. We cannot assure that we can maintain our current reinsurance facilities or that we can obtain other reinsurance facilities in adequate amounts and at favorable rates. Further, we cannot determine what effect catastrophic losses will have on the reinsurance market and on our ability to obtain adequate reinsurance at favorable rates. If we are unable to renew or to obtain new reinsurance facilities on acceptable terms, either our net exposures would increase or, if we are unwilling to bear such an increase in exposure, we would have to reduce the level of our underwriting commitments, especially in catastrophe-exposed risks. Either of these potential developments could have a material adverse effect on our financial position, results of operations and cash flows.

If the companies that provide our reinsurance do not pay all of our claims, we could incur severe losses.

We purchase reinsurance by transferring, or ceding, all or part of the risk we have assumed as a direct insurer to a reinsurance company in exchange for all or part of the premium we receive in connection with the risk. Through reinsurance, we have the contractual right to collect the amount reinsured from our reinsurers. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us of our full liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers.

We cannot assure that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis. Additionally, catastrophic losses from multiple direct insurers may accumulate within the more concentrated reinsurance market and result in claims that adversely impact the financial condition of such reinsurers and thus their ability to pay such claims. Further, additional adverse developments in the capital markets could affect our reinsurers ability to meet their obligations to us. If we become liable for risks we have ceded to reinsurers or if our reinsurers cease to meet their obligations to us, because they are in a weakened financial position as a result of incurred losses or otherwise, our financial position, results of operations and cash flows could be materially adversely affected.

As a direct insurer, we may have significant exposure for terrorist acts.

To the extent that reinsurers have excluded coverage for terrorist acts or have priced such coverage at rates that we believe are not practical, we, in our capacity as a direct insurer, do not have reinsurance protection and are exposed for potential losses as a result of any terrorist acts. To the extent an act of terrorism is certified by the Secretary of Treasury, we may be covered under the Terrorism Risk Insurance Program Reauthorization Act of 2007 for up to 85% of our losses in 2013, up to the maximum amount set out in the Reauthorization Act. However, any such coverage would be subject to a mandatory deductible of approximately $136.5 million in 2013.

In some jurisdictions outside of the United States, where we also have exposure to a loss from an act of terrorism, we have limited access to other government programs that may mitigate our exposure. If we become liable for risks that are not covered under the Reauthorization Act, our financial position, results of operations and cash flows could be materially adversely affected. In addition, because interpretation of this law is untested, there may be uncertainty as to how it will be applied to specific circumstances.

We may be unsuccessful in competing against larger or more well-established business rivals.

We face competition from other specialty insurance companies, standard insurance companies and underwriting agencies, as well as from diversified financial services companies that are larger than we are and that have greater financial, marketing and other resources than we do. Some of these competitors also have longer experience and more market recognition than we do in certain lines of business. In addition, it may be difficult or prohibitively expensive for us to implement IT systems and processes that are competitive with the systems and processes of these larger companies. We cannot assure that we will maintain our current competitive position in the markets in which we operate, or that we will be able to expand our operations into new markets. If we fail to do so, our results of operations and cash flows could be materially adversely affected.

We invest a significant amount of our assets in securities that have experienced market fluctuations, which may reduce the value of our investment portfolio, reduce investment income or generate realized investment losses.

At December 31, 2012, approximately 90% of our $7.0 billion investment portfolio was invested in fixed maturity securities. The fair value of these fixed maturity securities and the related investment income fluctuate depending on general economic and market conditions, including volatility in the financial markets and the economy as a whole. For our fixed maturity securities, the fair value generally increases or decreases in an inverse relationship with fluctuations in interest rates and credit spreads, while net investment income realized by us from future investments in fixed maturity securities will generally increase or decrease with interest rates. Mortgage-backed and asset-backed securities may have different net investment income and/or cash flows from those anticipated at the time of investment. These securities have prepayment risk because the timing of cash flows that result from the repayment of principal might occur earlier than anticipated, due to declining interest rates, or extension risk when cash flows may be received later than anticipated because of rising interest rates.

Although 98% of our portfolio is investment grade, all of our fixed maturity securities are subject to credit risk. For mortgage-backed securities, credit risk exists if mortgagors default on the underlying mortgages. During an economic downturn, our state, municipal and non-U.S. sovereign bond portfolios could be subject to a higher risk of default or impairments due to declining tax bases and revenue, notwithstanding the relatively low historical rates of default on these types of obligations. If any of the issuers of our fixed maturity securities suffer financial setbacks, the ratings on the fixed maturity securities could fall (with a concurrent fall in fair value) and, in a worst case scenario, the issuer could default on its financial obligations. If the issuer defaults, we could have realized losses associated with the impairment of the securities.

The impact of fluctuations in the market prices of securities affects our financial statements. Because all of our fixed maturity and equity securities are classified as available for sale, changes in the fair value of these securities are reflected in our other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our financial position. The unrealized pretax net investment gain on our available for sale securities was $436.7 million, $331.1 million and $134.7 million at December 31, 2012, 2011 and 2010, respectively.

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Since 2008, the financial markets and the economy have been severely affected by various events. This has impacted interest rates and has caused large writedowns in other companies financial instruments either due to the market fluctuations or the impact of the events on the debtors financial condition. Turmoil in the financial markets and the economy, particularly related to potential future ratings downgrade and/or impairment of debt securities of sovereign issuers, could adversely affect the valuation of our investments and cause us to have to record other-than-temporary impairment credit losses on our investments, which could have a material adverse effect on our financial position and results of operations.

If rating agencies downgrade our financial strength ratings, our business and competitive position in the industry may suffer.

Ratings have become an increasingly important factor in establishing the competitive position of insurance companies. Our insurance companies are rated by Standard & Poor s Corporation, Fitch Ratings, Moody s Investors Service, Inc. and/or A.M. Best Company, Inc. The financial strength ratings reflect the rating agencies opinions of an insurance company s and insurance holding company s financial strength, operating performance, strategic position and ability to meet its obligations to policyholders and are not evaluations directed to investors. Our ratings are subject to periodic review by those entities, and the continuation of those ratings at current levels cannot be assured. If our ratings are reduced from their current levels, it could affect our ability to compete for high quality business and, thus, our financial position and results of operations could be adversely affected.

We may require additional capital or funds for liquidity in the future, which may not be available or may only be available on unfavorable terms.

Our future capital and liquidity requirements depend on many factors, including our ability to write new business successfully, to establish premium rates and reserves at levels sufficient to cover losses, and to maintain our current line of credit. We may need to raise additional funds through financings or curtail our growth and reduce our assets. Any equity or debt financing, if available at all in periods of stress and volatility in the financial markets, may be on terms that are not favorable to us. In the case of equity financings, dilution to our shareholders could result and, in any case, such securities may have rights, preferences and privileges that are senior to those of our common stock. If we cannot obtain adequate capital or funds for liquidity on favorable terms or at all, our business, results of operations and liquidity could be adversely affected. We may also be pre-empted from making acquisitions.

Standard & Poor s Corporation, Fitch Ratings, Moody s Investors Service, Inc. and A.M. Best Company, Inc. rate our credit strength. If our credit ratings are reduced, it might significantly impede our ability to raise capital and borrow money, which could materially affect our business, results of operations and liquidity.

We may be unable to attract and retain qualified employees.

We depend on our ability to attract, retain and provide for the succession of skilled and experienced underwriting talent and other key employees (including our CEO, President/COO, CFO, senior executive officers and executives at our operating companies) who are knowledgeable about our business. Certain of our senior underwriters and other key employees have employment agreements that are for definite terms, and there is no assurance we will retain these employees beyond the current terms of their agreements. If the quality of our underwriting team and other key personnel decreases, we may be unable to maintain our current competitive position in the specialized markets in which we operate and be unable to expand our operations into new markets, which could materially adversely affect our business.

Our strategy of acquiring other companies and underwriting teams for growth may not succeed.

Our strategy for growth includes growing through acquisitions of insurance industry related companies. This strategy presents risks that could have a material adverse effect on our business and financial performance, including: 1) the diversion of our management s attention, 2) our ability to assimilate the operations and personnel of the acquired companies, 3) the contingent and latent risks associated with the past operations of, and other unanticipated problems arising in, the acquired companies, 4) the need to expand management, administration and operational systems and 5) increased competition for suitable acquisition opportunities and qualified employees.

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We cannot predict whether we will be able to find suitable acquisition targets, nor can we predict whether we would be able to acquire these additional companies on terms favorable to us or if we will be able to successfully integrate the acquired operations into our business. We do not know if we will realize any anticipated benefits of completed acquisitions or if there will be substantial unanticipated costs associated with new acquisitions. In addition, future acquisitions by us may result in potentially dilutive issuances of our equity securities, the incurrence of additional debt, and/or the recognition of potential impairment of goodwill and other intangible assets. Each of these factors could materially adversely affect our financial position and results of operations.

More recently, our growth has come through hiring underwriting teams focused on new lines of business. While more limited, many of the same risks above apply. Most notably, the diversion of management attention, the assimilation of new personnel and the need to expand management, administration and operational systems are present. Also, because these are new lines of business for which we have limited experience, the results of these new lines could materially adversely affect our financial position and results of operations.

We are exposed to goodwill impairment risk as part of our business acquisition strategy.

We have recorded goodwill in connection with the majority of our business acquisitions. We are required to perform goodwill impairment tests at least annually and whenever events or circumstances indicate that the carrying value may not be recoverable from estimated future cash flows. As a result of our annual and other periodic evaluations, we may determine that a portion of the goodwill carrying value needs to be written down to fair value, which could materially adversely affect our financial position and results of operations.

We are an insurance holding company and, therefore, may not be able to receive dividends in needed amounts from our insurance company subsidiaries.

In the past, we have had sufficient cash flow from our non-insurance company subsidiaries to meet our corporate cash flow requirements for paying principal and interest on outstanding debt obligations, dividends to shareholders and corporate expenses. More recently, we have relied on, and in the future we may rely on, dividends from our insurance companies to meet these requirements. The payment of dividends by our insurance companies is subject to regulatory restrictions and will depend on the surplus and future earnings of these subsidiaries, as well as the regulatory restrictions. As a result, should our other sources of funds prove to be inadequate, we may not be able to receive dividends from our insurance companies at times and in amounts necessary to meet our obligations, which could materially adversely affect our financial position and liquidity.

Because we operate internationally, fluctuations in currency exchange rates may affect our assets and liabilities.

We underwrite insurance coverages that are denominated in a number of foreign currencies, and we establish and maintain our loss reserves for these policies in their respective currencies. Our principal area of exposure relates to fluctuations in exchange rates between the British pound sterling, the Euro and the U.S. dollar. Consequently, a change in the exchange rate between the U.S. dollar and the British pound sterling or the Euro could have a material adverse effect on our financial position, results of operations and cash flows. We hold assets, primarily available for sale fixed maturity securities, denominated in comparable foreign currencies that are intended to economically hedge the foreign currency risk related to these reserves denominated in foreign currencies but there can be no assurances that we will be successful in these efforts.

Our information technology systems or third-party systems that we utilize or access may fail or suffer a loss of security, which could adversely affect our business.

Our business is highly dependent upon the successful and uninterrupted functioning of our computer systems. We rely on these systems to perform actuarial and other modeling functions necessary for writing business, to process our premiums and policies, to process and make claims payments, to establish our loss reserves, and to prepare our management and external financial statements and information. The failure of these systems could interrupt our operations. In addition, in the event of a disaster such as a natural catastrophe, a blackout, a computer virus, a terrorist attack or war, our systems may be inaccessible for an extended period of time. These systems failures or disruptions could result in a material adverse effect on our business results. We also utilize and/or rely on computer systems developed and maintained by outsourcing relationships and key vendors. Their systems could experience the same risks, which could result in a material adverse effect on our business results.

A security breach of our computer systems could damage our reputation or result in liability. We retain confidential information regarding our business dealings in our computer systems. We may be required to spend significant capital and other resources to protect against security breaches or to alleviate problems caused by such breaches. Despite the implementation of security measures, the infrastructure supporting our computer systems may be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. In addition, we could be subject to liability if hackers were able to penetrate our network security or otherwise misappropriate confidential information. Furthermore, certain of our businesses are subject to compliance with laws and regulations enacted by U.S. federal and state governments, the European Union or other jurisdictions or enacted by various regulatory organizations or exchanges relating to the privacy and security of the information of clients, employees or others. The compromise of personal, confidential or proprietary information could result in remediation costs, legal liability, regulatory action and reputational harm.

If we experience difficulties with outsourcing relationships, our ability to conduct our business might be negatively impacted.

We outsource certain business and administrative functions to third parties and may do so increasingly in the future. If we fail to develop and implement our outsourcing strategies or our third party providers fail to perform as anticipated, we may experience operational difficulties, increased costs and a loss of business that may have a material adverse effect on our results of operations or financial position. By outsourcing certain business and administrative functions to third parties, we may be exposed to enhanced risk of data security breaches. Any breach of data security could damage our reputation and/or result in monetary damages, which, could have a material adverse effect on our results of operations or financial condition.

We may not be able to delay or prevent an inadequate or coercive offer for change in control, and regulatory rules and required approvals might delay or deter a favorable change of control.

Our certificate of incorporation and bylaws do not have provisions that could make it more difficult for a third party to acquire a majority of our outstanding common stock. As a result, we may be more susceptible to an inadequate or coercive offer that could result in a change in control than a company whose charter documents have provisions that could delay or prevent a change in control.

Many state insurance regulatory laws contain provisions that require advance approval by state agencies of any change of control of an insurance company that is domiciled or, in some cases, has substantial business in that state. Control is generally presumed to exist through the ownership of 10% or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. We own, directly or indirectly, all of the shares of stock of insurance companies domiciled in a number of states. Any purchaser of shares of common stock representing 10% or more of the voting power of our common stock will be presumed to have acquired control of our domestic insurance subsidiaries unless, following application by that purchaser, the relevant state insurance regulators determine otherwise. Any transactions that would constitute a change in control of any of our individual insurance subsidiaries would generally require prior approval by the insurance departments of the states in which the insurance subsidiary is domiciled.

One of our insurance subsidiaries is domiciled in the United Kingdom and another in Spain. Insurers in those countries are also subject to change of control restrictions under their individual regulatory frameworks. These requirements may deter or delay possible significant transactions in our common stock or the disposition of our insurance companies to third parties, including transactions that could be beneficial to our shareholders.

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Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

Our principal and executive offices are located in Houston, Texas, in buildings owned by Houston Casualty Company. We also maintain offices in approximately 50 locations elsewhere in the United States, the United Kingdom, Spain and Ireland. The majority of these additional locations are in leased facilities.

Our major office facilities, with more than 25,000 square feet, are as follows:

Segment	Location	Square feet	Termination date of lease
U.S. Property & Casualty and Corporate headquarters	Houston, Texas	51,000	Owned
U.S. Property & Casualty	Houston, Texas	77,000	Owned
	Mount Kisco, New York	38,000	Owned
	Wakefield, Massachusetts	34,000	February 28, 2017
	Dallas, Texas	33,000	August 31, 2013
	Auburn Hills, Michigan	27,000	May 31, 2017
Accident & Health	Atlanta, Georgia	40,000	June 30, 2018
U.S. Surety & Credit	Los Angeles, California	41,000	October 31, 2016
International	London, England	30,000	December 24, 2015

Item 3. ***Legal Proceedings***

Litigation

We are a party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations 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, arbitrations and other proceedings that relate to disputes with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of any such matters will not, individually or in the aggregate, have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Item 4. ***Mine Safety Disclosures***

Not applicable.

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PART II

Item 5. ***Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Price Range of Common Stock

Our common stock trades on the New York Stock Exchange under the ticker symbol HCC . The intra-day high and low sales prices for quarterly periods in the last three years, as reported by the New York Stock Exchange, were as follows:

	2012		2011		2010	
	High	Low	High	Low	High	Low
First quarter	$ 31.71	$ 26.62	$ 32.00	$ 29.00	$ 29.00	$ 26.29
Second quarter	32.69	29.91	33.12	30.73	28.10	23.85
Third quarter	34.46	30.06	31.90	24.66	26.57	24.10
Fourth quarter	37.65	33.74	30.33	25.32	29.18	25.66

On February 15, 2013, the last reported sales price of our common stock as reported by the New York Stock Exchange was $39.97 per share.

Shareholders

We have one class of authorized capital stock. On February 15, 2013, there were 125.1 million shares of common stock issued and 100.6 million shares of common stock outstanding held by 615 shareholders of record; however, we estimate there are approximately 56,000 beneficial owners.

Dividend Policy

Cash dividends declared on a quarterly basis were as follows:

	2012	2011	2010
First quarter	$ 0.155	$ 0.145	$ 0.135
Second quarter	0.155	0.145	0.135
Third quarter	0.165	0.155	0.145
Fourth quarter	0.165	0.155	0.145

Beginning in June 1996, we announced a planned quarterly program of paying cash dividends to shareholders. Our Board of Directors may review our dividend policy from time to time, and any determination with respect to future dividends will be made in light of regulatory and other conditions at that time, including our earnings, financial condition, capital requirements, loan covenants and other related factors. Under the terms of our bank loan facility, we are prohibited from paying dividends in excess of an agreed upon maximum amount in any year. That limitation should not affect our ability to pay dividends in a manner consistent with our past practice and current expectations. We presently intend to continue dividend payments in an amount and frequency consistent with our past practice.

Issuer Purchases of Equity Securities

On September 23, 2011, the Board approved the purchase of up to $300.0 million of our common stock. On August 23, 2012, the Board approved a new authorization for $300.0 million (the Plan) and cancelled $98.0 million remaining under the previous authorization. Purchases under the Plan may be made in the open market or in privately negotiated transactions from time-to-time in compliance with applicable laws, rules and regulations, including Rule 10b-18 under the Securities Exchange Act of 1934, as amended. Purchases under the Plan will be made subject to market and business conditions, the

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level of cash generated from our operations, cash required for acquisitions, our debt covenant compliance, and other relevant factors. The Plan does not obligate us to purchase any particular number of shares, has no expiration date, and may be suspended or discontinued at any time at the Board s discretion. Our purchases in the fourth quarter of 2012 were as follows:

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs
October 1 - October 31, 2012	15,600	$33.94	15,600	$286,389,137
November 1 - November 30, 2012	573,338	$35.72	573,338	$265,907,563
December 1 - December 31, 2012	434,897	$37.07	434,897	$249,784,428
Total	1,023,835		1,023,835	

Performance Graphs

The following graph shows a comparison of cumulative total returns for an investment of $100.00 made on December 31, 2007 in the common stock of HCC Insurance Holdings, Inc., the Standard & Poor s 500 Index, and the Standard & Poor s 500 Property and Casualty Insurance Index. We previously used the Standard & Poor s Composite 1500 Index and the Standard & Poor s 1500 Multi-Line Insurance Index as comparisons to HCC. The five year total returns for the prior indices are presented in the second graph below. We believe the Standard & Poor s 500 Index and the Standard & Poor s 500 Property and Casualty Insurance Index are more representative of our industry peer group and our size. Both graphs assume that all dividends were reinvested.

Total Return to Shareholders

(includes reinvestment of dividends)

Company/Index	2007	2008	2009	2010	2011	2012
HCC Insurance Holdings, Inc.	$ 100.00	$ 95.09	$ 101.42	$ 107.15	$ 103.93	$ 143.35
S&P 500 Index	100.00	63.00	79.67	91.68	93.61	108.59
S&P 500 P&C Insurance Index	100.00	70.59	79.30	86.39	86.18	103.51

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The following graph shows a comparison of cumulative total returns for an investment of $100.00 made on December 31, 2007 in the common stock of HCC Insurance Holdings, Inc., the Standard & Poor s Composite 1500 Index, and the Standard & Poor s 1500 Multi-Line Insurance Index.

Total Return to Shareholders

(includes reinvestment of dividends)

Company/Index	2007	2008	2009	2010	2011	2012
HCC Insurance Holdings, Inc.	$ 100.00	$ 95.09	$ 101.42	$ 107.15	$ 103.93	$ 143.35
S&P Composite 1500 Index	100.00	63.28	80.52	93.71	95.35	110.76
S&P 1500 Multi-Line Insurance Index	100.00	13.56	17.96	21.96	17.05	21.45

These performance graphs shall not be deemed to be incorporated by reference into our Securities and Exchange Commission filings and should not constitute soliciting material or otherwise be considered filed under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended.

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Item 6. ***Selected Financial Data***

The selected consolidated financial data shown below has been derived from the Consolidated Financial Statements. All information contained herein should be read in conjunction with the Consolidated Financial Statements and related Notes, the Schedules, and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Report.

	Years ended December 31, (in thousands, except per share data)				
	2012	**2011 (5)**	**2010 (5)**	**2009 (5)**	**2008 (5)**
Revenue					
Net earned premium	$ 2,242,625	$ 2,127,170	$ 2,041,924	$ 2,037,235	$ 2,007,774
Net investment income	222,634	212,271	203,819	191,965	164,751
Other operating income	30,448	35,590	44,832	82,669	61,985
Net realized investment gain (loss)	31,148	3,653	12,104	12,076	(16,808)
Other-than-temporary impairment credit losses	(1,028)	(4,679)	(425)	(5,429)	(11,133)
Total revenue	2,525,827	2,374,005	2,302,254	2,318,516	2,206,569
Expense					
Loss and loss adjustment expense, net	1,305,511	1,399,247	1,213,029	1,215,759	1,211,873
Policy acquisition costs, net	281,201	266,125	255,136	240,679	250,682
Other operating expense	359,060	330,557	322,914	327,363	291,414
Interest expense	25,628	23,070	21,348	16,164	20,362
Total expense	1,971,400	2,018,999	1,812,427	1,799,965	1,774,331
Earnings before income tax expense	554,427	355,006	489,827	518,551	432,238
Income tax expense	163,187	99,763	144,731	164,683	130,118
Net earnings	$ 391,240	$ 255,243	$ 345,096	$ 353,868	$ 302,120
Net earnings attributable to unvested restricted stock	(6,982)	(3,864)	(3,926)	(1,928)	(449)
Net earnings attributable to common stock	$ 384,258	$ 251,379	$ 341,170	$ 351,940	$ 301,671
Earnings per common share					
Basic	$ 3.84	$ 2.31	$ 3.00	$ 3.14	$ 2.63
Diluted	$ 3.83	$ 2.30	$ 2.99	$ 3.11	$ 2.61
Weighted average shares outstanding					
Basic	100,176	109,051	113,863	112,200	114,848
Diluted	100,456	109,240	114,077	113,058	115,463
Cash dividends declared, per share	$ 0.64	$ 0.60	$ 0.56	$ 0.52	$ 0.47
Gross written premium	$ 2,784,073	$ 2,649,126	$ 2,578,908	$ 2,559,791	$ 2,498,763
Net written premium	$ 2,253,396	$ 2,182,158	$ 2,026,197	$ 2,046,289	$ 2,060,618

Net loss ratio (2)	58.2 %	65.8 %	59.4 %	59.7 %	60.4 %
Expense ratio (3)(4)	25.4	25.3	25.6	24.9	25.4
Combined ratio (4)	83.6 %	91.1 %	85.0 %	84.6 %	85.8 %

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	December 31,				
	2012	2011 (5)	2010 (5)	2009 (5)	2008 (5)
	(in thousands, except per share data)				
Balance sheet data					
Total investments	$ 6,950,398	$ 6,049,750	$ 5,687,095	$ 5,456,229	$ 4,804,283
Premium, claims and other receivables	549,725	688,732	635,867	600,332	770,823
Reinsurance recoverables	1,071,222	1,056,068	1,006,855	1,016,411	1,054,950
Ceded unearned premium	256,988	222,300	278,663	270,436	234,375
Goodwill	885,860	872,814	821,648	822,006	858,849
Total assets	$ 10,267,807	$ 9,597,278	$ 9,036,107	$ 8,806,416	$ 8,304,025
Loss and loss adjustment expense payable	3,767,850	3,658,317	3,471,858	3,492,309	3,415,230
Reinsurance, premium and claims payable	294,621	366,499	345,730	337,257	527,476
Unearned premium	1,069,956	1,031,034	1,045,877	1,044,747	977,426
Notes payable	583,944	478,790	298,637	298,483	343,649
Shareholders equity	$ 3,542,612	$ 3,273,982	$ 3,278,400	$ 3,013,151	$ 2,621,991
Book value per share (1)	$ 35.10	$ 31.45	$ 28.52	$ 26.42	$ 23.11
Shares outstanding	100,928	104,101	114,968	114,051	113,444

(1) Calculated by dividing outstanding shares into total shareholders equity.
(2) Calculated by dividing net incurred loss and loss adjustment expense by net earned premium.
(3) Calculated by dividing segment underwriting expense by segment revenue.
(4) 2011 2008 adjusted to reflect our exit from two lines of business previously included in our Accident & Health segment. See Note 12, Segments to the Consolidated Financial Statements.
(5) We adjusted certain prior period amounts to reflect our adoption of a new accounting standard in 2012. See Note 1, General Information and Significant Accounting and Reporting Policies Accounting Guidance Adopted in 2012 to the Consolidated Financial Statements. Adoption of this standard impacted our consolidated financial statements, as follows:

	Years ended December 31,			
	2011	2010	2009	2008
	(increase (decrease), in thousands)			
Statement of earnings data				
Policy acquisition costs, net	$ (62,009)	$ (66,910)	$ (67,875)	$ (57,905)
Other operating expense	62,009	66,910	67,875	57,905

	December 31,			
	2011	2010	2009	2008
	(decrease in thousands, except per share data)			
Balance sheet data				
Total assets (deferred policy acquisition costs)	$ (27,975)	$ (27,975)	$ (27,975)	$ (27,975)

Shareholders equity (retained earnings)	(18,032)	(18,032)	(18,032)	(18,032)
Book value per share	$ (0.17)	$ (0.15)	$ (0.16)	$ (0.16)

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following Management s Discussion and Analysis should be read in conjunction with the Selected Financial Data and the Consolidated Financial Statements and related Notes.

Overview

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain and Ireland, transacting business in approximately 180 countries. Our shares trade on the New York Stock Exchange and closed at $39.97 on February 15, 2013, resulting in market capitalization of $4.0 billion.

We underwrite and manage a variety of largely non-correlated specialty insurance products through five insurance underwriting segments and our Investing segment. Our insurance underwriting segments are U.S. Property & Casualty, Professional Liability, Accident & Health, U.S. Surety & Credit and International. We market our insurance products through a network of independent agents and brokers, through managing general agents owned by the company, and directly to consumers. In addition, we assume insurance written by other insurance companies.

Our organization is focused on generating consistent, industry-leading combined ratios. We concentrate our insurance writings in selected specialty lines of business in which we believe we can achieve meaningful underwriting profit. We rely on experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to limit or reduce risk. By focusing on underwriting profitability, we are able to accomplish our primary objectives of maximizing net earnings and growing book value per share.

Key facts about our consolidated group as of and for the year ended December 31, 2012 are as follows:

- We had consolidated shareholders equity of $3.5 billion, with a book value per share of $35.10.

- We generated net earnings of $391.2 million, or $3.83 per diluted share.

- We produced total revenue of $2.5 billion, of which 89% related to net earned premium and 9% related to net investment income.

- We recognized gross losses of $84.8 million and net losses, after reinsurance and reinstatement premium, of $52.8 million from accident year catastrophes, the largest being Superstorm Sandy, mainly in our International segment.

- Our net loss ratio was 58.2% and our combined ratio was 83.6%.

- We recorded net favorable loss development of $70.0 million.

- Our debt to capital ratio was 14.2%.

- We purchased $178.7 million of our common stock at an average cost of $32.09 per share. At year-end, we had $249.8 million remaining under our current $300.0 million share buyback authorization.

- We increased our regular quarterly cash dividend to $0.165 per share, marking the 16th consecutive year of increases in our dividend. We declared dividends of $0.64 per share and paid $64.3 million of dividends in 2012.

The following sections discuss our key operating results. The reason for any significant variations between 2011 and 2010 are the same as those discussed for variations between 2012 and 2011, unless otherwise noted. Amounts in tables are in thousands, except for earnings per share, percentages, ratios and number of employees. We adjusted certain prior period amounts to reflect our adoption of a new accounting standard in 2012 (see Note 1, General Information and Significant Accounting and Reporting Policies Accounting Guidance Adopted in 2012 to the Consolidated Financial Statements). We also adjusted all prior segment data to reflect our exit from two lines of business previously included in our Accident & Health segment (see Note 12, Segments to the Consolidated Financial Statements).

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Results of Operations

Our results and key metrics for the past three years were as follows:

	2012	2011	2010
Net earnings	$ 391,240	$ 255,243	$ 345,096
Earnings per diluted share	$ 3.83	$ 2.30	$ 2.99
Net loss ratio	58.2 %	65.8 %	59.4 %
Expense ratio*	25.4	25.3	25.6
Combined ratio*	83.6 %	91.1 %	85.0 %

* 2011 and 2010 adjusted to reflect 2012 change in Exited Lines.

Our results include the impact of catastrophic events around the world, including these major events: 1) 2012 Superstorm Sandy and United States storms, 2) 2011 Japan earthquake and tsunami, Hurricane Irene, New Zealand earthquakes, United States tornados, Denmark storms and Thailand floods and 3) 2010 Chile earthquake. These losses primarily impacted our International and U.S. Property & Casualty segments. We reinsure a portion of our exposure to catastrophic events, although we incur some additional cost for reinstatement premium to continue our reinsurance coverage for future loss events. The following table summarizes our accident year catastrophe losses, as well as the impact on our net earnings and key metrics.

	2012	2011	2010
Gross losses	$ 84,751	$ 175,468	$ 44,042
Net losses	$ 52,390	$ 103,907	$ 22,500
Reinstatement premium, net	401	14,008	(1,154)
Total net catastrophe losses	$ 52,791	$ 117,915	$ 21,346
Impact of net catastrophe losses on:			
Net earnings per diluted share	$ (0.34)	$ (0.70)	$ (0.12)
Net loss ratio (percentage points)	2.3 %	5.3 %	1.1 %
Combined ratio (percentage points)	2.4 %	5.4 %	1.1 %

We recognized net favorable loss development of $70.0 million in 2012, which included $21.4 million related to prior year catastrophes, compared to net adverse development of $10.1 million in 2011 and net favorable development of $22.7 million in 2010. See the Segment Operations section below for discussion of the impact of the catastrophe losses and the net loss development on each of our insurance underwriting segments.

Revenue

We generate our revenue from five primary sources:

risk-bearing earned premium produced by our insurance underwriting segments,

investment income earned on our consolidated investment portfolio by our Investing segment,

fee and commission income received from third party insurers for premium produced for them by our underwriting agencies,

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transaction-based revenues, primarily related to residual value and mortgage reinsurance products in our U.S. Property & Casualty segment, and

realized investment gains and losses related to our investment portfolio.

Total revenue increased $151.8 million in 2012, compared to 2011, primarily due to higher net earned premium, net investment income and net realized investment gains. Total revenue increased $71.8 million in 2011, compared to 2010, primarily due to higher net earned premium and net investment income, offset by lower other operating income and net realized investment gains.

Gross written premium, net written premium and net earned premium are detailed below by segment.

	2012	2011	2010
U.S. Property & Casualty	$ 614,694	$ 540,436	$ 538,475
Professional Liability	539,383	562,503	596,291
Accident & Health	835,796	757,097	707,103
U.S. Surety & Credit	221,468	226,312	226,866
International	531,167	517,383	453,478
Exited Lines	41,565	45,395	56,695
Total gross written premium	$ 2,784,073	$ 2,649,126	$ 2,578,908
U.S. Property & Casualty	$ 383,938	$ 367,296	$ 328,821
Professional Liability	378,138	412,262	401,562
Accident & Health	835,008	756,539	706,747
U.S. Surety & Credit	195,904	208,859	209,373
International	419,155	391,819	324,344
Exited Lines	41,253	45,383	55,350
Total net written premium	$ 2,253,396	$ 2,182,158	$ 2,026,197
U.S. Property & Casualty	$ 354,050	$ 333,410	$ 339,513
Professional Liability	394,687	410,816	425,226
Accident & Health	831,827	758,270	705,408
U.S. Surety & Credit	207,955	210,535	199,908
International	412,853	368,748	316,186
Exited Lines	41,253	45,391	55,683
Total net earned premium	$ 2,242,625	$ 2,127,170	$ 2,041,924

The 2012 and 2011 growth in premium from our insurance underwriting segments occurred primarily in: 1) the U.S. Property & Casualty segment, from new business lines started in 2011 and increased public risk, residual value and other premium; 2) the Accident & Health segment, from the growth of our medical stop-loss product and 3) the International segment, from new business and price increases in our energy and property treaty lines of business. See the Segment Operations section below for further discussion of the relationship and changes in premium revenue within each insurance segment.

Net investment income, which is included in our Investing segment, increased 5% in 2012 and 4% in 2011 due to growth in our investment portfolio, partially offset by the effect of reduced yields. Our fixed maturity securities portfolio increased 7% in 2012 and 13% in 2011, from $5.2 billion at December 31, 2010 to $5.9 billion at December 31, 2011 and $6.3 billion at December 31, 2012. In addition, we added publicly traded equity securities to our portfolio in 2012 and held $284.6 million at December 31, 2012. The growth in investments resulted primarily from cash flow from operations and an increase of $105.6 million in the net unrealized gain on our available for sale securities during 2012. Our investment expense increased in 2012 due to growth in the portfolio and management expenses for the equity securities.

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Our other operating income primarily consists of fee and commission income related to third party agency and broker commissions and income from two financial instruments. In 2010, we terminated one of these contracts and recognized $8.0 million of revenue, which was included in our U.S. Property & Casualty segment.

Loss and Loss Adjustment Expense

We incur expenses for insurance claims paid or payable to policyholders, as well as the potential liability for incurred but not reported claims, and the expense to adjust and settle all claims (collectively referred to as loss and loss adjustment expense). Our net loss ratio is the percentage of our loss and loss adjustment expense divided by our net earned premium in each year.

Loss development represents an increase or decrease in estimates of ultimate losses related to business written in prior accident years. Such increases or decreases are recorded as loss and loss adjustment expense in the current reporting year. Favorable development means the original ultimate loss estimate was higher than the current estimate. Adverse development means the current ultimate loss estimate is higher than the original estimate. Loss development occurs as we review our loss exposure with our actuaries, increasing or decreasing estimates of our ultimate losses as a result of such reviews and as losses are finally settled or claims exposure changes.

The tables below detail our net loss and loss adjustment expense, the amount of net loss development included in our net loss and loss adjustment expense, and our net loss ratios on a consolidated basis and for our segments.

	2012	2011	2010
U.S. Property & Casualty	$ 209,286	$ 201,017	$ 191,108
Professional Liability	229,873	328,503	265,465
Accident & Health	601,076	552,292	506,994
U.S. Surety & Credit	38,535	52,206	52,940
International	189,410	233,879	143,412
Exited Lines	37,331	31,350	53,110
Net loss and loss adjustment expense	$ 1,305,511	$ 1,399,247	$ 1,213,029
Net (favorable) adverse loss development			
U.S Property & Casualty	$ 2,321	$ (3,145)	$ (15,891)
Professional Liability	(25,897)	47,084	9,624
Accident & Health	(10,511)	(1,324)	1,374
U.S. Surety & Credit	(25,377)	(11,300)	(7,181)
International	(10,084)	(13,830)	(22,277)
Exited Lines	(463)	(7,338)	11,688
Total net (favorable) adverse loss development	(70,011)	10,147	(22,663)
Accident year catastrophe losses	52,390	103,907	22,500
All other net loss and loss adjustment expense	1,323,132	1,285,193	1,213,192
Net loss and loss adjustment expense	$ 1,305,511	$ 1,399,247	$ 1,213,029
U.S. Property & Casualty	59.1 %	60.3 %	56.3 %
Professional Liability	58.2	80.0	62.4
Accident & Health	72.3	72.8	71.9
U.S. Surety & Credit	18.5	24.8	26.5
International	45.9	63.4	45.4
Consolidated net loss ratio	58.2 %	65.8 %	59.4 %
Consolidated accident year net loss ratio	61.5 %	65.3 %	60.4 %

Loss and loss adjustment expense decreased 7% in 2012, compared to an increase of 15% in 2011. The 2012 decrease primarily related to: 1) net favorable loss development in 2012, compared to net adverse development in 2011, 2) lower

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accident year catastrophe losses in 2012 and 3) a slightly lower accident year loss ratio, excluding catastrophes, in 2012. The 2011 increase was driven by: 1) higher accident year catastrophe losses, primarily in the International segment and 2) an increase in reserves in 2011 to reflect a higher ultimate loss ratio for accident year 2011 for our diversified financial products (DFP) line of business in the Professional Liability segment. Our accident year net loss ratio was higher in 2011 due to the catastrophe losses and increased DFP reserves in that year. Excluding catastrophes, our accident year net loss ratio was 59.1% for 2012, 60.0% for 2011 and 59.4% for 2010. See the Segment Operations section below for additional discussion of the changes in our loss and loss adjustment expense, net development and net loss ratios for each segment.

Our net paid loss ratio is the percentage of losses paid, net of reinsurance, divided by net earned premium for the year. The table below provides a reconciliation of our consolidated reserves for loss and loss adjustment expense payable, net of reinsurance ceded, the amount of our paid claims, and our net paid loss ratio.

	2012	2011	2010
Net reserves for loss and loss adjustment expense payable at beginning of year	$ 2,683,483	$ 2,537,772	$ 2,555,840
Net reserve additions from acquired businesses	14,705	6,261	8,110
Foreign currency adjustment	18,449	(6,108)	(21,127)
Net loss and loss adjustment expense	1,305,511	1,399,247	1,213,029
Net loss and loss adjustment expense payments	(1,272,345)	(1,253,689)	(1,218,080)
Net reserves for loss and loss adjustment expense payable at end of year	$ 2,749,803	$ 2,683,483	$ 2,537,772
Net paid loss ratio	56.7 %	58.9 %	59.7 %

The amount of claims paid fluctuates year-over-year due to our mix of business, the timing of claims settlement and catastrophic events. Our net paid loss ratio decreased slightly in both 2012 and 2011 due to offsetting changes in the amount of claims paid across our different lines of business, such that our net loss payments have increased at a slower rate than our net earned premium. We commuted certain loss reserves on large contracts included in our Exited Lines for $27.5 million in 2012 and $26.7 million in 2011. The commutations had no material effect on net earnings but increased our net paid loss ratios by 1.2 and 1.3 percentage points in 2012 and 2011, respectively.

Policy Acquisition Costs

Policy acquisition costs relate to direct costs we incur to issue insurance policies, including commissions, premium taxes and compensation of our underwriters. The percentage of policy acquisition costs to net earned premium was 12.5% in all three years. We record profit commissions due from reinsurers as an offset to policy acquisition costs, which impacted our policy acquisition cost percentages as follows:

	2012	2011	2010
Profit commissions	$ 10,227	$ 17,194	$ 1,594
Impact of profit commissions (percentage points)	0.5 %	0.8 %	0.1 %

After excluding profit commissions, the difference between years primarily relates to changes in the mix of business.

Other Operating Expense

Other operating expense increased 9% in 2012 and 2% in 2011. In 2012, 61% of our other operating expense related to compensation and benefits for our 1,870 employees, compared to 62% in 2011 and 61% in 2010. The 2012 increase in other operating expense was primarily due to increased compensation expense, including higher bonus expense directly related to higher pretax earnings in 2012, and the year-over-year fluctuation in foreign currency benefit/expense. The 2011 increase related to higher compensation and benefits and information technology expense. We recognized foreign currency expense of $6.2 million in 2012, compared to a benefit of $1.1 million in 2011 and expense of $1.6 million in 2010, primarily related to fluctuations in the British pound sterling.

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Other operating expense included $13.2 million, $12.4 million and $13.6 million of stock-based compensation expense in 2012, 2011 and 2010, respectively. Stock-based compensation expense was lower in 2012 and 2011 due to the timing of vesting and forfeitures of awards. In 2012, we granted $11.2 million of restricted stock awards and units, with a weighted-average life of 3.2 years. At December 31, 2012, there was approximately $24.8 million of total unrecognized compensation expense related to unvested options and restricted stock awards and units that is expected to be recognized over a weighted-average period of 3.0 years. In 2013, we expect to recognize $9.9 million of expense for all stock-based awards outstanding at year-end 2012.

Interest Expense

Interest expense on debt and short-term borrowings was $25.6 million, $23.1 million and $21.3 million in 2012, 2011 and 2010, respectively. Our interest expense has increased due to a higher amount of outstanding borrowings on our $600.0 million Revolving Loan Facility, primarily to fund purchases of our common stock. Interest expense included $19.3 million per year for our Senior Notes.

Income Tax Expense

Our income taxes are due to U.S. Federal, state, local and foreign jurisdictions. Our effective income tax rate was 29.4% for 2012, compared to 28.1% for 2011 and 29.5% for 2010. The higher effective rates in 2012 and 2010 are due to the relationship of pretax income and tax-exempt investment income. Our pretax income was substantially higher in 2012 and 2010 than in 2011, whereas our tax-exempt investment income increased slightly each year. The lower effective rate in 2011 related to the increased benefit from tax-exempt investment income relative to a lower pretax income base.

Segment Operations

Each of our insurance segments bears risk for insurance coverage written within its portfolio of insurance products. Each segment generates income from premium written by our underwriting agencies, through third party agents and brokers, or on a direct basis. The insurance segments also write facultative or individual account reinsurance, as well as treaty reinsurance business. In some cases, we purchase reinsurance to limit the segments net losses from both individual policy losses and multiple policy losses from catastrophic risks. Our segments maintain disciplined expense management and a streamlined management structure, which results in favorable expense ratios.

A description of the type of products, distribution channels, risk exposure and other key facts about our five insurance underwriting segments is included in the Segment and Geographic Information section of Item 1, Business. The following provides operational information about our five insurance underwriting segments and our Investing segment.

U.S. Property & Casualty Segment

The following tables summarize the operations of the U.S. Property & Casualty segment.

	2012	2011	2010
Net earned premium	$ 354,050	$ 333,410	$ 339,513
Other revenue	18,865	23,951	31,201
Segment revenue	372,915	357,361	370,714
Loss and loss adjustment expense, net	209,286	201,017	191,108
Other expense	116,398	110,184	103,229
Segment expense	325,684	311,201	294,337
Segment pretax earnings	$ 47,231	$ 46,160	$ 76,377

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	2012	2011	2010
Net loss ratio	59.1 %	60.3 %	56.3 %
Expense ratio	31.2	30.8	27.8
Combined ratio	90.3 %	91.1 %	84.1 %
Aviation	$ 116,236	$ 113,341	$ 115,952
E&O	61,976	73,666	95,275
Public Risk	65,281	50,440	46,409
Other	110,557	95,963	81,877
Total net earned premium	$ 354,050	$ 333,410	$ 339,513
Aviation	56.2 %	63.7 %	55.0 %
E&O	70.9	70.8	79.2
Public Risk	94.1	79.8	61.8
Other	34.9	37.9	28.4
Total net loss ratio	59.1 %	60.3 %	56.3 %
Aviation	$ 144,621	$ 154,903	$ 162,539
E&O	60,639	68,846	81,567
Public Risk	85,857	73,168	64,802
Other	323,577	243,519	229,567
Total gross written premium	$ 614,694	$ 540,436	$ 538,475
Aviation	$ 112,712	$ 117,333	$ 110,539
E&O	58,066	67,606	81,443
Public Risk	69,081	58,096	46,844
Other	144,079	124,261	89,995
Total net written premium	$ 383,938	$ 367,296	$ 328,821

Our U.S. Property & Casualty segment pretax earnings increased 2% in 2012 due to higher net earned premium and a lower net loss ratio. The segment s pretax earnings decreased 40% in 2011 primarily due to: 1) lower net earned premium, 2) a reduced amount of favorable development in 2011 compared to 2010, 3) $6.2 million of catastrophe losses in 2011, 4) higher operating expenses and 5) the effect of a $5.0 million gain in 2010 related to termination of a derivative contract.

Net earned premium was higher in 2012 due to $14.3 million of additional premium from our new technical property, primary casualty and excess casualty underwriting teams, as well as increases in aviation, public risk, contingency, residual value and other premium. Premium grouped in Other includes numerous types of specialty insurance products, including the technical property, primary casualty and excess casualty lines of business. These new teams wrote $57.0 million of gross premium in 2012, compared to $16.7 million in 2011 and a minimal amount in 2010. In 2011 and again in 2012, we wrote less premium in some lines of business, particularly aviation and E&O, due to continued competition. Our public risk premium has grown primarily due to increased participation in one particular area of this business, as well as higher retention of the business beginning in 2011. Changes in the segment s net written premium relative to gross written premium are due to changes in timing and the amount of our reinsurance programs.

The segment experienced accident year net catastrophe losses of $11.3 million in 2012, compared to $6.2 million in 2011, of which $7.0 million and $5.0 million, respectively, related to our public risk line of business. The segment had net adverse loss development of $2.3 million in 2012, compared to net favorable development of $3.1 million in 2011 and $15.9 million

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in 2010. In 2012, the segment experienced favorable development in aviation and various lines of business included in Other, which was more than offset by adverse development in the E&O and public risk lines of business. The 2011 net favorable development primarily related to offsetting favorable and adverse loss development for products grouped in Other. The 2010 net favorable loss development primarily related to an assumed quota share contract that is in runoff, as well as aviation, public risk, and smaller product lines included in Other. Aviation experienced higher 2011 accident year losses and E&O experienced higher 2010 accident year losses, as well as adverse loss development in 2010 related to the 2006 2009 underwriting years.

The segment s expense ratio was higher in 2012 and 2011, primarily due to increasing compensation costs. In 2010, we terminated our interest in a derivative contract, which generated $8.0 million of other revenue and $3.0 million of other direct expenses in that year. The segment s remaining other revenue relates to fee and commission income earned by our agencies from third party insurance companies.

Professional Liability Segment

The following tables summarize the operations of the Professional Liability segment.

	2012	2011	2010
Net earned premium	$ 394,687	$ 410,816	$ 425,226
Other revenue	731	912	981
Segment revenue	395,418	411,728	426,207
Loss and loss adjustment expense, net	229,873	328,503	265,465
Other expense	66,721	59,036	74,524
Segment expense	296,594	387,539	339,989
Segment pretax earnings	$ 98,824	$ 24,189	$ 86,218
Net loss ratio	58.2 %	80.0 %	62.4 %
Expense ratio	16.9	14.3	17.5
Combined ratio	75.1 %	94.3 %	79.9 %
U.S. D&O	$ 332,661	$ 359,178	$ 377,868
International D&O	62,026	51,638	47,358
Total net earned premium	$ 394,687	$ 410,816	$ 425,226
U.S. D&O	64.6 %	90.3 %	62.6 %
International D&O	24.2	8.2	60.8
Total net loss ratio	58.2 %	80.0 %	62.4 %
U.S. D&O	$ 424,099	$ 453,669	$ 498,331
International D&O	115,284	108,834	97,960
Total gross written premium	$ 539,383	$ 562,503	$ 596,291

U.S. D&O	$ 311,576	$ 347,834	$ 362,255
International D&O	66,562	64,428	39,307
Total net written premium	$ 378,138	$ 412,262	$ 401,562

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The Professional Liability segment pretax earnings increased $74.6 million in 2012, compared to 2011, due to an improved accident year loss ratio and changes in loss development. Segment earnings decreased in 2011, compared to 2010, due to lower net earned premium and net adverse loss development, partially offset by increased income related to profit commissions due from reinsurers.

Gross written premium decreased 4% in 2012, primarily due to reduced writings in our DFP line of business (included in U.S. D&O) as we re-underwrote the DFP book of business in 2012. Gross written premium decreased 6% in 2011 because we wrote less D&O business in the United States due to pricing competition. Net written premium fluctuated year-over-year due to a change in our reinsurance program in both years.

The segment had net favorable loss development of $25.9 million in 2012, compared to net adverse development of $47.1 million in 2011 and $9.6 million in 2010. The 2012 development consisted of $9.0 million in U.S. D&O and $16.9 million in International D&O. The 2012 development related to lower than expected reported loss development in underwriting years 2003 2006, partially offset by higher expected losses in the 2008 underwriting year. The 2011 and 2010 development primarily related to our DFP line of business, which provides coverage for private equity partnerships, hedge funds, investment managers and similar groups. In 2011, DFP recorded $104.2 million of adverse development, as well as $37.3 million of additional losses related to our increase in the ultimate loss ratio for accident year 2011. These reserve changes resulted primarily from revised assumptions with regards to the frequency and severity of claims in the 2008 2011 accident years. Our U.S. D&O and International D&O lines of business had favorable development of $32.2 million and $24.9 million, respectively, in 2011, which partially offset the adverse development from DFP. The favorable D&O development related to lower than expected reported loss development in accident years 2002 2005.

U.S. D&O s 2012 net loss ratio includes the impact of using DFP s higher ultimate loss ratio in 2012 for DFP s underwriting year 2011 premium that earned in 2012. The 2011 net loss ratio for U.S. D&O included the impact of DFP s adverse development, partially offset by the favorable development for the U.S. D&O line of business. International D&O s lower loss ratios in 2012 and 2011, compared to 2010, directly related to favorable development in those years.

The fluctuations in the expense ratio primarily related to profit commissions of $5.1 million in 2012 and $13.5 million in 2011, recognized in conjunction with the favorable development in those years. The profit commissions, which offset the segment s other expense, reduced the 2012 and 2011 expense ratio by 1.3 and 3.3 percentage points, respectively. There were minimal profit commissions in 2010.

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Accident & Health Segment

The following tables summarize the operations of the Accident & Health segment.

	2012	2011	2010
Net earned premium	$ 831,827	$ 758,270	$ 705,408
Other revenue	4,918	4,684	3,872
Segment revenue	836,745	762,954	709,280
Loss and loss adjustment expense, net	601,076	552,292	