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

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

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended June 30, 2003.

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from _______ to __________

Commission file number 001-13790

HCC Insurance Holdings, Inc.
(Exact name of registrant as specified in its charter)

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

(713) 690-7300
(Registrant's telephone number, including area code)

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

Yes X No ______

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

Yes X No ______

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

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

HCC INSURANCE HOLDINGS, INC.

INDEX

Part I. FINANCIAL INFORMATION
Item 1. Financial Statements
Condensed Consolidated Balance Sheets
June 30, 2003 and December 31, 2002 ....

Condensed Consolidated Statements of Earnings
For the six months and three months ended June 30, 2003 and 2002 ....

Condensed Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2003.......................................

Condensed Consolidated Statements of Cash Flows
For the six months and three months ended June 30, 2003 and 2002 ....

Notes to Condensed Consolidated Financial Statements..........................

Item 2. Management's Discussion and Analysis..

Item 3. Quantitative and Qualitative Disclosures About Market Risk....................

Item 4. Controls and Procedures...

Part II. OTHER INFORMATION
Item 1. Legal Proceedings...

Item 4. Submission of Matters to Vote of Security Holders.............................

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

Signatures..

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

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

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

2

HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(unaudited, in thousands, except per share data)

	June 30, 2003	December
ASSETS		
Investments:		
Fixed income securities, at market (cost: 2003 - $976,833; 2002 - $807,772)	$1,019,438	$ 841
Marketable equity securities, at market (cost: 2003 - $15,118; 2002 - $15,815)	15,120	15
Short-term investments, at cost, which approximates market	396,977	307
Other investments, at estimated fair value (cost: 2003 - $2,170; 2002 - $3,264)	2,170	3
Total investments	1,433,705	1,167
Cash	16,259	40
Restricted cash	224,909	189
Premium, claims and other receivables	923,473	753
Reinsurance recoverables	863,018	798
Ceded unearned premium	230,037	164
Ceded life and annuity benefits	78,575	78
Deferred policy acquisition costs	101,873	68
Goodwill	334,360	335
Other assets	157,153	107
TOTAL ASSETS	$4,363,362	$3,704

LIABILITIES		
Loss and loss adjustment expense payable	$1,305,123	$1,155
Life and annuity policy benefits	78,575	78
Reinsurance balances payable	230,924	166
Unearned premium	497,770	331
Deferred ceding commissions	68,028	49
Premium and claims payable	850,389	749
Notes payable	311,639	230
Accounts payable and accrued liabilities	60,131	59
Total liabilities	3,402,579	2,821
SHAREHOLDERS' EQUITY		
Common stock, $1.00 par value; 250.0 million shares authorized; (shares issued and outstanding: 2003 - 63,188; 2002 - 62,358)	63,188	62
Additional paid-in capital	429,868	416
Retained earnings	440,113	383
Accumulated other comprehensive income	27,614	20
Total shareholders' equity	960,783	882
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$4,363,362	$3,704

See Notes to Condensed Consolidated Financial Statements.

3

HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(unaudited, in thousands, except per share data)

	For the six months ended June 30, 2003	2002	F
REVENUE			
Net earned premium	$ 345,914	$ 226,105	
Management fees	49,541	38,995	
Commission income	28,352	21,228	
Net investment income	22,870	17,984	
Net realized investment gain	184	1,169	
Other operating income	5,139	2,140	
Total revenue	452,000	307,621	

EXPENSE		
Loss and loss adjustment expense	220,112	136,083
Operating expense:		
Policy acquisition costs, net	41,458	25,534
Compensation expense	55,068	39,541
Other operating expense	29,612	23,992
Net operating expense	126,138	89,067
Interest expense	3,596	4,841
Total expense	349,846	229,991
Earnings before income tax provision	102,154	77,630
Income tax provision	37,217	27,566
Net earnings	$ 64,937	$ 50,064
BASIC EARNINGS PER SHARE DATA:		
Earnings per share	$ 1.03	$ 0.81
Weighted average shares outstanding	62,753	62,087
DILUTED EARNINGS PER SHARE DATA:		
Earnings per share	$ 1.02	$ 0.80
Weighted average shares outstanding	63,667	62,805
Cash dividends declared, per share	$ 0.13	$ 0.125

See Notes to Condensed Consolidated Financial Statements.

HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Changes in Shareholders' Equity

For the six months ended June 30, 2003

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

	Common Stock	Additional paid-in Capital	Retained earnings
BALANCE AS OF DECEMBER 31, 2002	$ 62,358	$ 416,406	$ 383,378
Net earnings	--	--	64,937
Other comprehensive income	--	--	--
Comprehensive income			
778 shares of common stock issued for exercise of options, including tax benefit of $2,323	778	13,514	--
Issuance of 52 shares of contractually issuable common stock	52	(52)	--
Cash dividends declared, $0.13 per share	--	--	(8,202)
BALANCE AS OF JUNE 30, 2003	$ 63,188	$ 429,868	$ 440,113

See Notes to Condensed Consolidated Financial Statements.

HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(unaudited, in thousands, except per share data)

	For the six months ended June 30, 2003	2002	For the 2003
Cash flows from operating activities:			
Net earnings	$ 64,937	$ 50,064	$ 34,6
Adjustments to reconcile net earnings to			

net cash provided by operating activities:			
Change in premium, claims and other receivables	(169,946)	(37,451)	(107,7
Change in reinsurance recoverables	(64,084)	30,036	(17,0
Change in ceded unearned premium	(65,813)	(39,310)	(41,3
Change in loss and loss adjustment expense payable	149,833	(35,164)	70,9
Change in reinsurance balances payable	64,265	38,459	35,4
Change in unearned premium	166,720	68,379	110,4
Change in premium and claims payable, net of restricted cash	65,353	(41,378)	23,6
Depreciation and amortization expense	5,564	5,378	2,5
Other, net	(17,557)	7,669	(14,1
Cash provided by operating activities	199,272	46,682	97,4
Cash flows from investing activities:			
Sales of fixed income securities	123,181	154,164	27,9
Maturity or call of fixed income securities	69,086	19,691	41,7
Sales of equity securities	1,165	3,417	1
Other proceeds	16,846	--	16,8
Change in short-term investments	(89,563)	41,502	58,6
Cost of securities acquired	(407,875)	(287,100)	(243,6
Earnout payments for purchase of subsidiaries	(4,079)	--	(4,0
Purchases of property and equipment	(3,135)	(2,838)	(1,6
Cash used by investing activities	(294,374)	(71,164)	(103,9
Cash flows from financing activities:			
Proceeds from notes payable, net of costs	134,845	40,000	
Sale of common stock, net of costs	11,969	9,261	8,2
Payments on notes payable	(67,622)	(13,269)	(
Dividends paid and other, net	(8,137)	(8,944)	(4,0
Cash provided by financing activities	71,055	27,048	4,0
Net change in cash	(24,047)	2,566	(2,5
Cash at beginning of period	40,306	16,891	18,7
CASH AT END OF PERIOD	$ 16,259	$ 19,457	$ 16,2

See Notes to Condensed Consolidated Financial Statements

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, in thousands, except per share data)

(1) GENERAL INFORMATION

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

Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include all adjustments which are, in our opinion, necessary for a fair presentation of the results of the interim periods. All adjustments made to the interim periods are of a normal recurring nature. The condensed consolidated financial statements include the accounts of HCC Insurance Holdings, Inc. and those of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated. The condensed consolidated financial statements for periods reported should be read in conjunction with the annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet as of December 31, 2002, was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

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

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

Income Tax

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

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(1) GENERAL INFORMATION, CONTINUED

Stock Options

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

	For the six months ended June 30,		For the three June
	2003	2002	2003
Reported net earnings	$ 64,937	$ 50,064	$ 34,662
Stock-based compensation using fair value method, net of income tax	(3,871)	(2,283)	(1,932)
Pro forma net earnings	$ 61,066	$ 47,781	$ 32,730
Reported basic earnings per share	$ 1.03	$ 0.81	$ 0.55
Fair value stock-based compensation	(0.06)	(0.04)	(0.03)
Pro forma basic earnings per share	$ 0.97	$ 0.77	$ 0.52
Reported diluted earnings per share	$ 1.02	$ 0.80	$ 0.54
Fair value stock-based compensation	(0.06)	(0.04)	(0.03)
Pro forma diluted earnings per share	$ 0.96	$ 0.76	$ 0.51

Reclassifications

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

8

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(2) REINSURANCE

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

	Written Premium	Earned Premium	Loss and Loss Adjustment Expense
For the six months ended June 30, 2003:			
Direct business	$ 654,610	$ 538,255	$ 335,912
Reinsurance assumed	202,117	153,833	168,660
Reinsurance ceded	(413,135)	(346,174)	(284,460)
NET AMOUNTS	$ 443,592	$ 345,914	$ 220,112
For the six months ended June 30, 2002:			
Direct business	$ 436,780	$ 378,086	$ 261,158
Reinsurance assumed	116,840	104,996	29,266
Reinsurance ceded	(295,958)	(256,977)	(154,341)
NET AMOUNTS	$ 257,662	$ 226,105	$ 136,083

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

For the three months ended June 30, 2003:			
Direct business	$ 357,830	$ 282,384	$ 168,696
Reinsurance assumed	119,449	91,885	116,833
Reinsurance ceded	(226,188)	(190,777)	(165,449)
NET AMOUNTS	$ 251,091	$ 183,492	$ 120,080
For the three months ended June 30, 2002:			
Direct business	$ 244,690	$ 193,527	$ 117,942
Reinsurance assumed	61,162	55,468	10,166
Reinsurance ceded	(170,462)	(134,368)	(60,356)
NET AMOUNTS	$ 135,390	$ 114,627	$ 67,752

(2) REINSURANCE, CONTINUED

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

	June 30, 2003	December 31, 2
Reinsurance recoverable on paid losses	$ 109,506	$ 108,104
Reinsurance recoverable on outstanding losses	440,459	437,162
Reinsurance recoverable on incurred but not reported losses	322,649	260,810
Reserve for uncollectible reinsurance	(9,596)	(7,142)
TOTAL REINSURANCE RECOVERABLES	$ 863,018	$ 798,934

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

	June 30, 2003	December 31, 2002
Payables to reinsurers	$ 334,190	$ 235,727
Letters of credit	150,314	141,490
Cash deposits	9,102	9,384
TOTAL CREDITS	$ 493,606	$ 386,601

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

	June 30, 2003	Dece
Loss and loss adjustment expense payable	$ 1,305,123	$
Reinsurance recoverable on outstanding losses	(440,459)	
Reinsurance recoverable on incurred but not reported losses	(322,649)	
NET RESERVES	$ 542,015	$
Unearned premium	$ 497,770	$
Ceded unearned premium	(230,037)	
NET UNEARNED PREMIUM	$ 267,733	$
Deferred policy acquisition costs	$ 101,873	$
Deferred ceding commissions	(68,028)	
NET DEFERRED POLICY ACQUISITION COSTS	$ 33,845	$

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(2) REINSURANCE, CONTINUED

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

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION

The performance of each segment is evaluated based upon net earnings and is calculated after tax and after all corporate expense allocations, purchase price allocations and intercompany eliminations have been charged or credited to the individual segments. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated. During the second quarter of 2003 we reclassified one of our subsidiaries, which was acquired in December 2002, from the underwriting agency segment to the intermediary segment in order to better match our segment presentation with the way we make decisions and assess performance. This reclassification has been made in all 2003 tables presented.

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

	Insurance Company	Underwriting Agency	Intermediary	Other Operati
For the six months ended June 30, 2003:				
Revenue:				
Domestic	$ 266,776	$ 44,834	$ 11,971	$ 4,
Foreign	100,035	5,774	17,170	
Inter-segment	--	23,680	1,472	
TOTAL SEGMENT REVENUE	$ 366,811	$ 74,288	$ 30,613	$ 4,
Inter-segment revenue				
CONSOLIDATED TOTAL REVENUE				
Net earnings:				
Domestic	$ 31,960	$ 19,090	$ 3,017	$ 1,
Foreign	7,201	1,901	3,039	
TOTAL SEGMENT NET EARNINGS	$ 39,161	$ 20,991	$ 6,056	$ 1,
Inter-segment eliminations				
CONSOLIDATED NET EARNINGS				
Other items:				
Net investment income	$ 20,226	$ 1,242	$ 591	$
Depreciation and amortization	1,617	1,463	1,077	
Interest expense (benefit)	25	3,411	1,790	
Capital expenditures	1,231	668	888	

Income tax provision	19,201	13,130	3,660
Inter-segment eliminations			
CONSOLIDATED INCOME TAX PROVISION			

12

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

	Insurance Company	Underwriting Agency	Intermediary	Other Operation
For the six months ended June 30, 2002:				
Revenue:				
Domestic	$ 210,079	$ 39,917	$ 12,502	$ 605
Foreign	33,948	591	9,189	--
Inter-segment	--	12,878	355	--
TOTAL SEGMENT REVENUE	$ 244,027	$ 53,386	$ 22,046	$ 605
Inter-segment revenue				
CONSOLIDATED TOTAL REVENUE				
Net earnings:				
Domestic	$ 30,239	$ 11,399	$ 2,884	$ 295
Foreign	2,740	257	1,268	--
TOTAL SEGMENT NET EARNINGS	$ 32,979	$ 11,656	$ 4,152	$ 295
Inter-segment eliminations				

CONSOLIDATED NET EARNINGS

Other items:				
Net investment income	$ 15,974	$ 1,330	$ 464	$ 27
Depreciation and amortization	1,518	3,111	170	66
Interest expense	73	3,880	1,288	--
Capital expenditures	1,007	800	695	--
Income tax provision	16,014	7,305	3,581	52
Inter-segment eliminations				
CONSOLIDATED INCOME TAX PROVISION				

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

	Insurance Company	Underwriting Agency	Intermediary	Other Operatio
For the three months ended June 30, 2003:				
Revenue:				
Domestic	$ 137,916	$ 23,740	$ 6,432	$ 4,20
Foreign	56,146	3,696	8,405	-
Inter-segment	--	12,536	660	-
TOTAL SEGMENT REVENUE	$ 194,062	$ 39,972	$ 15,497	$ 4,20
Inter-segment revenue				
CONSOLIDATED TOTAL REVENUE				

Net earnings:				
Domestic	$ 15,987	$ 10,345	$ 1,475	$ 2,52
Foreign	3,814	1,415	1,197	-
TOTAL SEGMENT NET EARNINGS	$ 19,801	$ 11,760	$ 2,672	$ 2,52
Inter-segment eliminations				
CONSOLIDATED NET EARNINGS				
Other items:				
Net investment income	$ 10,197	$ 581	$ 319	$
Depreciation and amortization	796	87	776	8
Interest expense	16	1,599	1,152	19
Capital expenditures	791	151	587	-
Income tax provision	10,440	7,570	1,365	1,15
Inter-segment eliminations				
CONSOLIDATED INCOME TAX PROVISION				

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

	Insurance Company	Underwriting Agency	Intermediary	Other Operations
For the three months ended June 30, 2002:				
Revenue:				
Domestic	$ 106,666	$ 20,211	$ 7,363	$ 312
Foreign	17,153	84	3,946	--

Inter-segment	--	6,743	99	--
TOTAL SEGMENT REVENUE	$ 123,819	$ 27,038	$ 11,408	$ 312
Inter-segment revenue				
CONSOLIDATED TOTAL REVENUE				
Net earnings (loss):				
Domestic	$ 15,875	$ 6,164	$ 2,319	$ 230
Foreign	2,204	(1)	124	--
TOTAL SEGMENT NET EARNINGS (LOSS)	$ 18,079	$ 6,163	$ 2,443	$ 230
Inter-segment eliminations				
CONSOLIDATED NET EARNINGS				
Other items:				
Net investment income	$ 8,282	$ 615	$ 242	$ 7
Depreciation and amortization	760	1,504	84	16
Interest expense (benefit)	--	1,894	644	--
Capital expenditures	505	376	405	--
Income tax provision	8,695	4,168	1,880	61
Inter-segment eliminations				
CONSOLIDATED INCOME TAX PROVISION				

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(3) SEGMENT AND GEOGRAPHIC INFORMATION, CONTINUED

The following tables present revenue by line of business within each operating segment for the periods indicated:

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

	For the six months ended June 30, 2003	2002	For the three mo 2003
Insurance company:			
Group life, accident and health	$ 147,509	$ 105,805	$ 75,526
Diversified financial products	44,818	7,277	26,512
London market account	66,457	32,521	37,081
Aviation	48,237	50,754	24,355
Other specialty lines of business	19,081	8,982	9,553
	326,102	205,339	173,027
Discontinued lines of business	19,812	20,766	10,465
TOTAL NET EARNED PREMIUM	$ 345,914	$ 226,105	$ 183,492
Underwriting agency:			
Group life, accident and health	$ 18,676	$ 25,026	$ 10,159
Property and casualty	30,865	13,969	16,924
TOTAL MANAGEMENT FEES	$ 49,541	$ 38,995	$ 27,083
Intermediary:			
Group life, accident and health	$ 16,630	$ 16,480	$ 8,368
Property and casualty	11,722	4,748	6,064
TOTAL COMMISSION INCOME	$ 28,352	$ 21,228	$ 14,432

(4) EARNINGS PER SHARE

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

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

	For the six months ended June 30, 2003	2002	For the three m 2003
Net earnings	$ 64,937	$ 50,064	$ 34,662
Reconciliation of shares outstanding:			
Shares of common stock outstanding at period end	63,188	62,232	63,188
Effect of common shares issued during the period	(435)	(197)	(321)
Common shares contractually issuable in the future	--	52	--
Weighted average common shares outstanding	62,753	62,087	62,867
Additional dilutive effect of outstanding options (as determined by the application of the treasury stock method)	914	718	1,123
Weighted average shares and potential common shares outstanding	63,667	62,805	63,990
Anti-dilutive shares not included in computation	499	364	174

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(5) NOTES PAYABLE

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

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

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

HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

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

(6) SUPPLEMENTAL INFORMATION

	For the six months ended June 30, 2003	2002	For the three months 2003
Interest paid	$ 2,721	$ 2,417	$ 290
Income tax paid	32,102	13,020	26,171
Comprehensive income	71,786	55,132	42,334
Ceding commissions netted with policy acquisition costs	98,077	66,164	53,474

(7) COMMITMENTS AND CONTINGENCIES

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

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS

Results of Operations

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

Total revenue increased 47% to $452.0 million for the first six months of 2003 from $307.6 million for the same period in 2002. The revenue increase resulted from premium rate increases, increased business in all segments and subsidiaries acquired during 2002.

Net investment income increased 27% to $22.9 million for the first six months of 2003 from $18.0 million for the same period in 2002. This increase was due to the higher level of invested assets resulting primarily from cash flow generated by operating activities and from the insurance company we acquired in December, 2002. Cash flow from operating activities was $199.3 million for the first six months of 2003 compared to $46.7 million for the same period in 2002, continuing a trend of increasing operating cash flow that began in 2002. The majority of the increase in cash flow from operations results from increased earnings and net premium flow into our insurance companies. We expect the positive cash flow provided by operating activities to continue, most of which will increase invested assets and thus the related investment income. If market interest rates were to rise, the growth in investment income would be accelerated as our current portfolio has a relatively short average duration and would be available to be invested on a longer term basis to take advantage of higher rates. For the first six months of 2003 our annualized, weighted average, tax equivalent yield was 4.3% compared to 4.2% for the same period in 2002.

Compensation expense increased to $55.1 million during the first six months of 2003 from $39.5 million for the same period in 2002. Most of this increase is due to subsidiaries acquired during 2002.

Other operating expense increased to $29.6 million during the first six months of 2003 compared to $24.0 million in 2002, again primarily due to subsidiaries acquired during 2002. Currency gains amounted to $0.8 million during the first six months of 2003 compared to gains of $0.4 million during the same period in 2002. In addition in 2003 there was a one-time currency gain of $1.3 million from the settlement of an advance of funds to an unaffiliated entity. During the first six months of 2003 our insurance company subsidiaries incurred unusually high special assessments from certain states and state agencies of $5.4 million compared to $1.0 million during the same period in 2002. Assessments of this magnitude are not expected in the future.

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

Income tax expense was $37.2 million for the first six months of 2003 compared to $27.6 million for the same period in 2002. Our effective tax rate was 36.4% in the 2003 period compared to 35.5% in 2002. The increased rate results from a reduction of the positive effect of tax exempt interest net of a reduction of the effect of state income taxes as our income before tax increases, especially in our insurance companies which are generally not subject to state income taxes, as well as immaterial adjustments made to refine our various tax accrual amounts.

Net earnings increased 30% to $64.9 million, or $1.02 per diluted share, for the first six months of 2003 from $50.1 million, or $0.80 per diluted share, for the same period in 2002. The increase in net earnings resulted from continuing good margins on increasing revenue and the effect of acquisitions consummated in 2002.

As of June 30, 2003, total assets exceeded $4.3 billion, shareholders' equity was $960.8 million and book value per share was $15.21, up from $14.15 as of December 31, 2002.

SEGMENTS

Insurance Companies

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

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

Expense Ratio

Combined Ratio

	Gross written premium	Net written premium	Net Earned Premium
For the six months ended June 30, 2002:			
Group life, accident and health	$245,659	$107,028	$105,805
Diversified financial products	58,369	15,133	7,277
London market account	116,053	61,939	32,521
Aviation	104,104	52,054	50,754
Other specialty lines of business	9,884	8,965	8,982
	534,069	245,119	205,339

Discontinued lines of business	19,551	12,543	20,766
TOTALS	$553,620	$257,662	$226,105

Expense Ratio

Combined Ratio

Gross written premium increased 55% to $856.7 million for the first six months of 2003 from $553.6 million for the same period in 2002. All of the lines of business showed some increase as a result of increases in premium rates as well as organic growth, but the largest growth was in the diversified financial products line of business, which our insurance companies began writing in 2002. Net written premium for the first six months of 2003 increased 72% to $443.6 million and net earned premium increased 53% to $345.9 million. The increase in premium is expected to continue throughout 2003 and into 2004.

Loss and loss adjustment expense was $220.1 million for the first six months of 2003 compared to $136.1 million for the same period in 2002. The net loss ratio was 63.6% for the first six months of 2003 compared to 60.2% for the same period in 2002. Prior year net reserve deficiency included in loss and loss adjustment expense approximated $9.8 million for the first six months of 2003 compared to a redundancy of $1.9 million for the same period in 2002. For the same periods, the gross loss ratio was 72.9% in 2003 compared to 60.1% in 2002. During the first six months of 2003, we increased our gross losses by $76.1 million on certain assumed accident and health reinsurance contracts reported in the discontinued line of business due to our processing of additional information received and our continuing evaluation of reserves related to this business. This had the effect of increasing our aggregate gross loss ratio by 9.3%. During the first six months of 2002, we reduced our gross losses from the September 11 terrorist attacks by $21.5 million, which had the effect of reducing our gross loss ratio by 4.5%. As these assumed reinsurance contracts and September 11 losses were substantially reinsured, there was no material effect on our net losses.

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

Policy acquisition costs, which are net of commissions on reinsurance ceded, increased to $41.5 million during the first six months of 2003, from $25.5 million in the same period in 2002. This increase is in proportion to the increase in net earned premium.

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

Underwriting Agencies

Management fees increased 27% to $49.5 million for the first six months of 2003 compared to $39.0 million for the same period in 2002. This growth was both from acquisitions made during 2002 and from internal growth, partially offset by decreases from underwriting agencies consolidated into our insurance companies during prior years. Net earnings in this segment increased to $21.0 million in the first six months of 2003 from $11.7 million in 2002 for the same reasons. We expect this growth to continue into 2004.

Intermediaries

Commission income increased 34% to $28.4 million for the first six months of 2003 compared to $21.2 million for the same period in 2002 due to improved market conditions, growth in non-affiliated business and an acquisition made during 2002. Net earnings of our intermediaries increased to $6.1 million for the first six months of 2003 compared to $4.2 million for the same period of 2002 for the same reasons. We expect this growth to continue into 2004.

Other Operations

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

Corporate

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

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

Total revenue increased 55% to $241.3 million for the second quarter of 2003 from $155.9 million for the same period in 2002. The revenue increase resulted from premium rate increases, increased business in all segments and subsidiaries acquired during 2002.

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

Compensation expense increased to $28.7 million during the second quarter of 2003 from $19.9 million for the same period in 2002. Most of this increase is due to subsidiaries acquired during 2002.

Other operating expense increased to $14.8 million during the second quarter of 2003 compared to $11.4 million in 2002, again primarily due to subsidiaries acquired during 2002. Currency gains amounted to $0.8 million during the second quarter of 2003 compared to gains of $0.6 million during the same period in 2002. In addition in 2003 there was a one-time currency gain of $1.3 million from the settlement of an advance of funds to an unaffiliated entity. During the second quarter of 2003 our insurance company subsidiaries incurred unusually high special assessments from certain states and state agencies of $3.0 million compared to $0.6 million during the same period in 2002. Assessments of this magnitude are not expected in the future.

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

Income tax expense was $20.2 million for the second quarter of 2003 compared to $15.1 million for the same period in 2002. Our effective tax rate was 36.9% in the 2003 quarter compared to 36.1% in 2002. The increased rate results from a reduction of the positive effect of tax exempt interest net of a reduction of the effect of state income taxes as our income before tax increases, especially in our insurance companies which are generally not subject to state income taxes, as well as immaterial adjustments made to refine our various tax accrual amounts.

Net earnings increased 29% to $34.7 million, or $0.54 per diluted share, for the second quarter of 2003 from $26.8 million, or $0.43 per diluted share, for the same period in 2002. The increase in net earnings resulted from continuing good margins on increasing revenue and the effect of acquisitions consummated in 2002.

As of June 30, 2003, total assets exceeded $4.3 billion, shareholders' equity was $960.8 million and book value per share was $15.21, up from $14.56 as of

March 31, 2003.

SEGMENTS

Insurance Companies

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

	Gross written premium	Net written premium	Net Earned Premium
For the three months ended June 30, 2003:			
Group life, accident and health	$144,162	$ 81,168	$ 75,526
Diversified financial products	143,106	48,907	26,512
London market account	79,434	65,322	37,081
Aviation	64,429	30,525	24,355
Other specialty lines of business	25,176	21,256	9,553
	456,307	247,178	173,027
Discontinued lines of business	20,972	3,913	10,465
TOTALS	$477,279	$251,091	$183,492
			Expense Ratio
			Combined Ratio
For the three months ended June 30, 2002:			
Group life, accident and health	$122,755	$ 55,208	$ 54,238
Diversified financial products	42,556	7,792	4,574
London market account	68,508	33,403	16,269
Aviation	59,990	29,421	25,571
Other specialty lines of business	5,682	5,384	5,347
	299,491	131,208	105,999
Discontinued lines of business	6,361	4,182	8,628
TOTALS	$305,852	$135,390	$114,627
			Expense Ratio
			Combined Ratio

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

Loss and loss adjustment expense was $120.1 million for the second quarter of 2003 compared to $67.8 million for the same period in 2002. The net loss ratio was 65.4% for the second quarter of 2003 compared to 59.1% for the same period in 2002. Prior year net reserve deficiency included in loss and loss adjustment expense approximated $8.5 million for the second quarter of 2003 compared to a redundancy of $0.2 million for the same period in 2002. For the same periods, the gross loss ratio was 76.3% in 2003 compared to 51.5% in 2002. During the second quarter of 2003, we increased our gross losses by $61.1 million on certain assumed accident and health reinsurance contracts reported in the discontinued line of business due to our processing of additional information received and our continuing evaluation of reserves related to this business. This had the effect of increasing our aggregate gross loss ratio by 13.2%. During the second quarter of 2002, we reduced our gross losses from the September 11 terrorist attacks by $21.5 million which had the effect of reducing our gross loss ratio by 8.6%. As these assumed reinsurance contracts and September 11 losses were substantially reinsured, there was no material effect on our net losses.

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

Policy acquisition costs, which are net of commissions on reinsurance ceded, increased to $20.9 million during the second quarter of 2003, from $12.5 million in the same period in 2002. This increase is in proportion to the increase in net earned premium.

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

Underwriting Agencies

Management fees increased 38% to $27.1 million for the second quarter of 2003 compared to $19.6 million for the same period in 2002. This growth was both from acquisitions made during 2002 and from internal growth, partially offset by decreases from underwriting agencies consolidated into our insurance companies during prior years. Net earnings in this segment increased to $11.8 million in the second quarter of 2003 from $6.2 million in 2002 for the same reasons and we expect this growth to continue into 2004.

Intermediaries

Commission income increased 30% to $14.4 million for the second quarter of 2003 compared to $11.1 million for the same period in 2002 due to improved market conditions, growth in non-affiliated business and from an

acquisition made in 2002. Net earnings of our intermediaries increased to $2.7 million for the second quarter of 2003 compared to $2.4 million for the same period of 2002 for the same reasons. We expect this growth to continue in 2004.

Other Operations

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

Corporate

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

Liquidity and Capital Resources

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

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

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

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

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

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

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

Critical Accounting Policies

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

a. Evaluation of disclosure controls and procedures.

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

b. Changes in internal controls.

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

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 4. Submission of Matters to Vote of Security Holders

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

Election of Directors.

The following persons were elected to serve on the Board of Directors until the 2004 Annual Meeting of Shareholders or until their successors have been duly elected and qualified. The Directors received the votes set forth opposite their respective names:

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

Walter J. Lack	46,831,778	4,693,993
Michael A. F. Roberts	46,830,114	4,695,657

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification by Chief Executive Officer.

31.2 Certification by Chief Financial Officer.

32.1 Certification with respect to quarterly report.

(b) Reports on Form 8-K

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

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

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

SIGNATURES

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

HCC Insurance Holdings, Inc.

(Registrant)

August 13, 2003	/s/ Stephen L. Way
(Date)	Stephen L. Way, Chairman of the Board, Chief Executive Officer and President
August 13, 2003	/s/ Edward H. Ellis, Jr.
(Date)	Edward H. Ellis, Jr., Executive Vice President and Chief Financial Officer

EXHIBIT INDEX

EXHIBIT NO.	DESCRIPTION
31.1	Certification by Chief Executive Officer.
31.2	Certification by Chief Financial Officer.
32.1	Certification with respect to quarterly report.