

Kiraly Robert G
Form 4
June 19, 2012

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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Form 4 or
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See Instruction
1(b).

**STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF
SECURITIES**

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934,
Section 17(a) of the Public Utility Holding Company Act of 1935 or Section
30(h) of the Investment Company Act of 1940

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(Print or Type Responses)

1. Name and Address of Reporting Person *
Kiraly Robert G

2. Issuer Name **and** Ticker or Trading
Symbol
FLUSHING FINANCIAL CORP
[FFIC]

5. Relationship of Reporting Person(s) to
Issuer

(Check all applicable)

(Last) (First) (Middle)
1979 MARCUS AVENUE, SUITE
E140

3. Date of Earliest Transaction
(Month/Day/Year)
06/17/2012

____ Director ____ 10% Owner
X Officer (give title below) ____ Other (specify below)
Senior Vice President

(Street)
LAKE SUCCESS, NY 11042

4. If Amendment, Date Original
Filed(Month/Day/Year)

6. Individual or Joint/Group Filing(Check
Applicable Line)
X Form filed by One Reporting Person
____ Form filed by More than One Reporting
Person

(City) (State) (Zip)

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
Common Stock	06/17/2012	06/17/2012	F	218 ⁽¹⁾ D \$ 12.93	18,141	D	
Common Stock					7,725 ⁽²⁾	I	401(K)

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)	5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)	6. Date Exercisable and Expiration Date (Month/Day/Year)	7. Title and Amount of Underlying Securities (Instr. 3 and 4)	8. Price of Derivative Security (Instr. 5)
Phantom Stock Units	(3)			Code V (A) (D)		Date Exercisable (4) Expiration Date (4)	Title Common Stock	Amount or Number of Shares 352

Reporting Owners

Reporting Owner Name / Address	Relationships
	Director 10% Owner Officer Other
Kiraly Robert G 1979 MARCUS AVENUE SUITE E140 LAKE SUCCESS, NY 11042	Senior Vice President

Signatures

Signed by Russell A. Fleishman Under Power of Attorney by Robert G. Kiralt 06/19/2012

__Signature of Reporting Person

Date

Explanation of Responses:

- * If the form is filed by more than one reporting person, see Instruction 4(b)(v).
 ** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Shares withheld to satisfy tax liability upon vesting of restricted stock units.

(2) Shares held in FSB 401(K) Savings Plan as of 6/18/2012.

(3) 1:1

(4) Includes amounts credited to Mr. Kiraly's account through 6/17/2012. The vested amount will be paid in cash lump sum installments as elected by the reporting officer upon termination of employment (in accordance with IRS 409A).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure. Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. agreements with various reinsurers to commute certain reinsurance recoverables, some of which related to our discontinued accident and health line of business. In 2005 and 2003, we received cash payments that were less than the related recoverables, from certain reinsurers, in consideration for discounting the recoverables

and reassuming the associated loss reserves. We recorded pre-tax losses of \$26.0 million in 2005 and \$28.8 million in 2003 related to these commutations, which were included in loss and loss adjustment expense in our insurance company segment.

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The following table shows the reported amounts, as well as the effect of the hurricanes and commutations on those amounts. The impact on ceded earned premium relates to the effect of premiums to reinstate our excess of loss reinsurance, which reduced net earned premium.

	Effect of hurricanes and commutations					
	2005	2004	2003	2005	2004	2003
	(As restated)	(As restated)	(As restated)			
Gross incurred loss and loss adjustment expense	\$ 1,596,773	\$ 1,289,155	\$ 1,045,339	\$ 394,625	\$ 89,795	\$
Net incurred loss and loss adjustment expense	919,697	645,230	488,000	99,226	23,335	28,751
Ceded earned premium	617,402	849,610	748,799	16,533	9,806	
Net earnings (loss)	191,192	162,699	142,027	(75,171)	(21,464)	(18,688)
Diluted earnings (loss) per share	1.75	1.65	1.47	(0.69)	(0.22)	(0.19)

The following table shows our net loss, expense and combined ratios and the effect that the losses related to the hurricanes and commutations had on these ratios. To determine the effect of the hurricanes and commutations, we calculated the 2005, 2004 and 2003 net loss ratios by excluding \$99.2 million, \$23.3 million and \$28.8 million, respectively, of losses from the numerator of the net loss ratio and \$16.5 million and \$9.8 million of reinstatement premium from the denominator of both the net loss ratio and the expense ratio in 2005 and 2004, respectively.

	2005	2004	2003
	(As restated)	(As restated)	(As restated)
Ratios:			
Net loss ratio	67.1%	63.8%	66.1%
Expense ratio	26.1	26.7	24.6
Combined ratio	93.2%	90.5%	90.7%
Effect of hurricanes and commutations:			
Net loss ratio	7.9%	2.9%	3.9%
Expense ratio	0.3	0.3	
Combined ratio	8.2%	3.2%	3.9%

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The following table sets forth the relationships of certain income statement items as a percent of total revenue.

	2005 (As restated)	2004 (As restated)	2003 (As restated)
Net earned premium	83.4%	78.7%	78.4%
Fee and commission income	8.1	14.3	15.1
Net investment income	6.0	5.1	5.0
Net realized investment gain	0.1	0.4	0.1
Other operating income	2.4	1.5	1.4
 Total revenue	 100.0	 100.0	 100.0
Loss and loss adjustment expense, net	56.0	50.2	51.8
Policy acquisition costs, net	15.9	17.3	14.6
Other operating expense	11.0	13.1	15.3
Interest expense	0.5	0.7	0.8
 Earnings from continuing operations before income tax expense	 16.6	 18.7	 17.5
Income tax expense	5.1	6.3	6.3
 Earnings from continuing operations	 11.5%	 12.4%	 11.2%

Total revenue increased 28% to \$1.6 billion in 2005 and 36% to \$1.3 billion in 2004, driven by significant growth in net earned premium and investment income, which more than offset the expected decrease in fee and commission income in 2005. Approximately 6% of the increase in 2005 revenue and 16% of the increase in 2004 revenue was due to the acquisition of subsidiaries. We expect total revenue to continue to grow in 2006.

Gross written premium, net written premium and net earned premium are detailed below. Premium increased from organic growth, particularly in our diversified financial products line of business, acquisitions and, with respect to net premiums, from increased retentions. See the Insurance Company Segment section below for further discussion of the relationship and changes in premium revenue.

	2005	2004	2003
Gross written premium	\$ 2,038,286	\$ 1,975,153	\$ 1,739,894
Net written premium	1,501,224	1,105,519	865,502
Net earned premium	1,369,988	1,010,692	738,272

The table below shows the source of our fee and commission income.

	2005 (As restated)	2004 (As restated)	2003
Agencies	\$ 94,972	\$ 127,453	\$ 105,899
Insurance companies	37,656	56,349	43,244
Other			(6,528)
 Fee and commission income	 \$ 132,628	 \$ 183,802	 \$ 142,615

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Fee and commission income decreased to \$132.6 million in 2005, as expected, resulting from a decrease in the level of ceded reinsurance by our insurance company subsidiaries, which resulted in reduced revenue from our reinsurance brokers and reduced ceding commissions earned by our insurance companies and underwriting agencies. Also, effective January 1, 2005, we consolidated the operations of our largest underwriting agency into one of our life insurance company subsidiaries. This higher retention of our premium and the consolidation of operations resulted in increased underwriting revenue and profitability in our insurance company subsidiaries. Fee and commission income increased 29% in 2004, primarily due to new business from subsidiaries acquired in 2003.

The sources of net investment income are detailed below.

	2005	2004	2003
Fixed income securities	\$ 77,842	\$ 55,929	\$ 40,927
Short-term investments	21,208	9,735	7,422
Other investments	3,615	1,366	488
Total investment income	102,665	67,030	48,837
Investment expense	(3,814)	(2,145)	(1,502)
Net investment income	\$ 98,851	\$ 64,885	\$ 47,335

Net investment income increased 52% in 2005 and 37% in 2004. These increases were primarily due to higher investment assets, which increased to \$3.3 billion at December 31, 2005 compared to \$2.5 billion at December 31, 2004 and \$1.7 billion at December 31, 2003. The growth in investment assets resulted from: 1) cash flow from operations, 2) higher retentions, 3) commutations of reinsurance recoverables, 4) our public offerings of common stock in 2005 and 2004 and 5) the increase in net loss reserves particularly from our diversified financial products line of business, which generally has a longer time period between reporting and payment of claims. Additionally, average yields on our short-term investments increased from 1.7% in 2004 to 2.7% in 2005. We continue to invest our funds primarily in fixed income securities, extending their duration to 4.9 years at the end of 2005 from 4.6 years and 3.7 years at the end of 2004 and 2003, respectively, and have increased the percentage of tax-exempt municipal bonds in our investment portfolio. We expect investment assets to continue to increase in 2006, consistent with our anticipated growth in revenue and earnings. If market interest rates rise, investment income will accelerate, since new funds and current maturities could be invested at higher rates.

At December 31, 2005, our unrealized loss on fixed income securities was \$8.5 million, down from an unrealized gain of \$20.7 million at December 31, 2004, due to increases in market interest rates. The change in the unrealized gain or loss, net of the related income tax effect, is recorded in other comprehensive income. This loss is unlikely to affect net earnings as we typically hold our fixed income securities to maturity when we receive the full principal amount.

Other operating income increased \$20.4 million in 2005 and \$6.2 million in 2004. The 2005 increase related primarily to gains from strategic investments, higher gains on sales of trading securities and a \$4.3 million gain on the sale of a dormant subsidiary. The 2004 increase included \$4.3 million income from two mortgage impairment insurance policies treated as derivatives and a \$1.5 million gain from the sale of a building. Period to period comparisons in this category may vary substantially depending on market values of trading securities and other financial instruments and on income from strategic investments or dispositions of such investments. The following table details the components of other operating income.

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	2005	2004	2003
Trading securities	\$ 16,619	\$ 2,604	\$ 5,583
Strategic investments	10,241	5,103	3,212
Sale of non-operating assets	4,271	1,531	
Financial instruments	3,898	4,297	
Other	4,744	5,871	4,420
Other operating income	\$ 39,773	\$ 19,406	\$ 13,215

Loss and loss adjustment expense increased 43% in 2005 and 32% in 2004 due to the 2005 and 2004 hurricane losses and the 2005 commutation, as well as growth in net retained premium in both years. Policy acquisition costs increased 18% in 2005 and 62% in 2004, primarily due to the growth in net earned premium. See the Insurance Company Segment section below for further discussion of the changes in loss and loss adjustment expense and policy acquisition costs.

Other operating expense, which includes compensation expense, increased 8% in 2005 and 16% in 2004. The increases primarily related to higher incentive compensation based on increased profitability, operating expenses of subsidiaries acquired or formed, and the expensing of \$8.9 million for an indemnification claim in 2005 and \$10.1 million to cover estimated settlement costs related to pending litigation in 2004. We had 1,448 employees at December 31, 2005, compared to 1,268 a year earlier. The increase in employees was primarily due to acquisitions. Our effective income tax rate on earnings from continuing operations was 30.9% for 2005, compared to 34.1% for 2004 and 36.0% for 2003. The effective tax rate decreased because our tax exempt interest income increased as a percentage of our pre-tax income in both 2004 and 2005, and we recorded a special \$2.8 million repatriation tax benefit in 2005.

In December 2003, we sold the business of our retail brokerage subsidiary, HCC Employee Benefits, Inc., for \$62.5 million in cash. We recognized a gain of \$52.7 million (\$30.1 million after-tax) in 2003 and additional gains of \$6.3 million (\$4.0 million after-tax) in 2004 and \$4.4 million (\$2.8 million after-tax) in 2005 from a contractual earnout, which is now completed. The after-tax earnings from discontinued operations and the after-tax gain on sale are reported as earnings from discontinued operations in the consolidated statements of earnings. Cash flows from the subsidiary's 2003 operations are included with cash flows from continuing operations within each major category of the consolidated statements of cash flows. Cash flows from the sale and earnout are included in investing activities. At December 31, 2005, book value per share was \$15.26, up from \$12.99 at December 31, 2004 and \$10.91 at December 31, 2003. Total assets were \$7.0 billion and shareholders' equity was \$1.7 billion, up from \$5.9 billion and \$1.3 billion, respectively, at December 31, 2004.

Segments

We operate our businesses in three segments: 1) insurance company, 2) agency and 3) other operations. Our Chairman and Chief Executive Officer, as chief decision maker, monitors and evaluates the individual financial results of each subsidiary in the insurance company and agency segments. Each subsidiary provides monthly reports of its actual and budgeted results, which are aggregated on a segment basis for management review and monitoring. The operating results of our insurance company and agency segments are discussed below.

Insurance Company Segment

Net earnings of our insurance company segment increased 15% to \$126.1 million in 2005 compared to \$109.3 million in 2004, which in turn increased 45% from \$75.3 million in 2003. The 2005 net earnings included \$75.2 million of after-tax losses related to hurricanes and a commutation, while 2004 net earnings included \$21.5 million of after-tax hurricane losses and 2003 net earnings included an \$18.7 million after-tax commutation loss. The growth in segment net earnings was driven by: 1) improved underwriting results, 2) increased retentions, which resulted in higher earned premium, 3)

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increased investment income and 4) the operations of acquired subsidiaries. Effective January 1, 2005, we consolidated the operations of our largest underwriting agency into one of our life insurance companies, which reduced fee and commission income of our agency segment but increased the underwriting profitability of our insurance company segment. Even though there is some pricing competition in certain of our markets, our margins remain at an acceptable level of profitability due to our underwriting expertise and discipline. We expect net earnings from our insurance companies to continue to grow in 2006.

Premium

Gross written premium increased 3% to \$2.0 billion in 2005 and 14% in 2004. We expect gross written premium to be relatively flat in 2006. Net written premium increased 36% to \$1.5 billion and net earned premium increased 36% to \$1.4 billion in 2005 compared to increases of 28% and 37%, respectively, in 2004. These increases were primarily due to higher retention levels on most non-catastrophe business, acquisitions and the mix of business due to increased premium in lines where we had greater retentions. The overall percentage of retained premium increased to 74% in 2005 from 56% in 2004 and 50% in 2003. Net written and net earned premium are expected to continue to grow in 2006.

The following table details premium amounts and their percentages of gross written premium.

	2005		2004		2003	
	Amount	%	Amount	%	Amount	%
Primary	\$ 1,768,284	87%	\$ 1,674,075	85%	1,377,999	\$ 79%
Reinsurance assumed	270,002	13	301,078	15	361,895	21
Gross written premium	2,038,286	100	1,975,153	100	1,739,894	100
Reinsurance ceded	(537,062)	(26)	(869,634)	(44)	(874,392)	(50)
Net written premium	1,501,224	74	1,105,519	56	865,502	50
Change in unearned premium	(131,236)	(7)	(94,827)	(5)	(127,230)	(8)
Net earned premium	\$ 1,369,988	67%	\$ 1,010,692	51%	\$ 738,272	42%

The following tables provide premium information by line of business.

	Gross	Net	NWP	Net
	written	written	as %	earned
	premium	premium	of	premium
			GWP	
<u>Year ended December 31, 2005</u>				
Diversified financial products	\$ 908,526	\$ 675,942	74%	\$ 531,136
Group life, accident and health	593,382	502,805	85	504,382
Aviation	210,530	130,743	62	136,197
London market account	144,425	78,809	55	93,017
Other specialty lines	176,139	109,106	62	97,721
Discontinued lines	5,284	3,819	nm	7,535
Totals	\$ 2,038,286	\$ 1,501,224	74%	\$ 1,369,988

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	Gross written premium	Net written premium	NWP as % of GWP	Net earned premium
<u>Year ended December 31, 2004</u>				
Diversified financial products	\$ 857,299	\$ 404,870	47%	\$ 310,809
Group life, accident and health	584,747	343,996	59	343,913
Aviation	204,963	144,687	71	127,248
London market account	178,950	107,509	60	111,341
Other specialty lines	133,964	83,980	63	69,089
Discontinued lines	15,230	20,477	nm	48,292
Totals	\$ 1,975,153	\$ 1,105,519	56%	\$ 1,010,692
<u>Year ended December 31, 2003</u>				
Diversified financial products	\$ 553,501	\$ 183,560	33%	\$ 123,562
Group life, accident and health	565,494	299,913	53	290,009
Aviation	214,718	99,447	46	97,536
London market account	223,149	155,987	70	137,572
Other specialty lines	73,475	36,837	50	12,443
Discontinued lines	109,557	89,758	nm	77,150
Totals	\$ 1,739,894	\$ 865,502	50%	\$ 738,272

nm Not meaningful comparison

The changes in premium volume and retention levels between years resulted principally from the following factors:

Diversified financial products The largest gross and net premium growth in 2005 and 2004 was in our diversified financial products line of business. We experienced significant growth in our directors' and officers' liability gross written premium in 2004. In response to some increased competition and a reduction in available reinsurance at an acceptable cost, we scaled back our writing of this business in 2005. Rates for the other products in this line have been relatively stable with the exception of surety for which rates have been increasing. Our professional indemnity and surety business increased in 2005 due to organic growth and acquisitions. The growth in net written and net earned premium in both years was due to increased retentions resulting from a reduction in proportional reinsurance, some of which has been replaced by excess of loss reinsurance.

Group life, accident and health Profit margins remain at acceptable levels despite increased competition from the fully insured market. We increased our retentions in 2005 and 2004 as this line of business generally is not volatile and has very little catastrophe exposure.

Aviation Our aviation premium retention levels were mostly unchanged in 2005 after excluding the effects of a portfolio transfer that occurred in 2004. This 2004 portfolio transfer recaptured ceded unearned premium and increased net written premium, but not gross written premium, as a result of a reduction in ceded reinsurance. There has been increasing competition in the international aviation component of this line, but margins are still acceptable. Our domestic business is very stable.

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London market account We reduced our London market account premium writings in 2004 and again in 2005, due to more selective underwriting in response to reduced premium rates from increased competition. Premium rates have generally increased in 2006 as a result of the hurricane losses. Net written premium was reduced by \$18.7 million in 2005 and \$15.3 million in 2004 for additional excess of loss premium to reinstate catastrophe reinsurance coverage, which distorts the retention percentages. Because of the catastrophe exposure, we purchase excess of loss reinsurance at a significant cost. Since there generally is a fixed minimum cost, the retention percentage decreases as our written premium decreases.

Other specialty lines We experienced organic growth in our other specialty lines of business from increased writings in several products. The mix of products will affect the retention percentages. Rates in this line have been relatively stable.

Reinsurance

Annually, we analyze our overall threshold for risk in each line of business based upon a number of factors including market conditions, pricing, competition and the inherent risks associated with the business type, then structure a specific reinsurance program for each of our lines of business. Based on our analysis of these factors, we may determine not to purchase reinsurance for some lines of business. We generally purchase reinsurance to reduce our net liability on individual risks, to protect against catastrophe losses and volatility and to achieve a desired ratio of net written premium to policyholders' surplus. We purchase reinsurance on a proportional basis to cover loss frequency, individual risk severity and catastrophe exposure. Some of the proportional insurance agreements may have maximum loss limits, which are currently well above a 100% combined ratio. We also purchase reinsurance on an excess of loss basis to cover individual risk severity and catastrophe exposure. Additionally, we may obtain facultative reinsurance protection on a single risk. The type and amount of reinsurance we purchase varies year to year based on our risk assessment, our desired retention levels based on profitability and other considerations, and the market availability of quality reinsurance at prices we consider acceptable. Our reinsurance programs renew throughout the year and, during 2005, some of those renewals contained price increases, which were not material to our net underwriting results. Our reinsurance generally does not cover war or terrorism risks, which are excluded from most of our policies.

We decided for the 2005 underwriting year to retain more underwriting risk in certain lines of business with the intention of retaining a greater proportion of any underwriting profits. In doing so, we will necessarily purchase less reinsurance applicable to that line or choose to restructure the applicable reinsurance programs, obtaining more excess of loss reinsurance and less proportional reinsurance, which significantly reduces the amount of ceded premium. Also, we have chosen not to purchase any reinsurance on other business where volatility or catastrophe risks are considered remote.

In our proportional reinsurance programs, we generally receive an overriding (ceding) commission on the premium ceded to reinsurers. This compensates our insurance companies for the direct costs associated with the production of the business, the servicing of the business during the term of the policies ceded and the costs associated with the placement of the related reinsurance. In addition, certain of our reinsurance treaties allow us to share in any net profits generated under such treaties with the reinsurers. Various reinsurance brokers, including subsidiaries, arrange for the placement of this proportional and other reinsurance coverage on our behalf and are compensated, directly or indirectly, by the reinsurers.

We have a reserve of \$12.1 million at December 31, 2005 for potential collectibility issues related to reinsurance recoverables, including disputed amounts and associated expenses. While we believe the reserve is adequate based on information currently available, conditions may change or additional information might be obtained which may require us to change the reserve in the future. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

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The table below shows the composition of gross incurred loss and loss adjustment expense.

	2005		2004		2003 (As restated)	
	Amount	Loss ratio	Amount	Loss ratio	Amount	Loss ratio
2005 hurricanes	\$ 394,625	19.9%	\$	%	\$	%
2004 hurricanes	(13,423)	(0.7)	89,795	4.8		
Other reserve redundancies	(7,080)	(0.4)	(11,594)	(0.6)	(10,423)	(0.7)
Discontinued line of business adjustments	49,775	2.5	127,707	6.9	132,924	8.9
All other gross incurred loss and loss adjustment expense	1,172,876	59.0	1,083,247	58.2	922,838	62.1
Gross incurred loss and loss expense adjustment	\$ 1,596,773	80.3%	\$ 1,289,155	69.3%	\$ 1,045,339	70.3%

Our gross reserve development relating to prior year losses was \$29.3 million in 2005, \$116.1 million in 2004 and \$122.5 million in 2003.

We increased our gross losses related to prior accident years on certain assumed accident and health reinsurance contracts reported in our discontinued line of business by \$49.8 million in 2005, \$127.7 million in 2004 and \$132.9 million in 2003 due to our processing of additional information received and our continuing evaluation of gross and net reserves related to this business. We considered a combination of factors including: 1) the nature of the business, which is primarily excess of loss reinsurance, 2) late reported losses by insureds, reinsureds and state guaranty associations and 3) changes in our actuarial assumptions to reflect additional information received during the year. The assumed accident and health business is primarily reinsurance that provides excess coverage for large losses related to workers compensation policies. This business is slow to develop and may take as many as twenty years to pay out. Primary losses must develop first before the excess coverage attaches. Thus, the losses are reported to excess of loss reinsurers later in the life cycle of the claim. Compounding this late reporting is the fact that a number of large insurance companies that were cedants of this business failed and were taken over by state regulatory authorities in 2002 and 2003. The state guaranty associations covering these failed companies have been slow to report losses to us. Based on the higher amount of actual losses reported, we revised the expected loss ratios used in our actuarial calculations. After consideration of all available information, we increased our gross and net reserves to amounts that management determined were appropriate to cover losses projected, given the risk inherent in this type of business. Reserves at December 31, 2005, although in excess of the actuarial point estimate, are within the actuarial range for this business.

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The table below shows the composition of net incurred loss and loss adjustment expense.

	2005 (As restated)		2004		2003 (As restated)	
	Loss		Loss		Loss	
	Amount	ratio	Amount	ratio	Amount	ratio
				%		%
2005 hurricanes	\$ 73,185	5.3%	\$		\$	
2004 hurricanes	(7,167)	(0.5)	23,335	2.3		
Commutations	26,041	1.9			28,751	3.9
Discontinued line of business adjustments	8,929	0.7	27,326	2.7		
Other reserve deficiencies (redundancies)	(2,409)	(0.2)	3,152	0.3	(5,637)	(0.8)
All other net incurred loss and loss adjustment expense	821,118	59.9	591,417	58.5	464,886	63.0
Net incurred loss and loss adjustment expense	\$ 919,697	67.1%	\$ 645,230	63.8%	\$ 488,000	66.1%

The discontinued line of business and hurricane losses were substantially reinsured; therefore, the net losses are substantially less than the gross losses in each year. Our net adverse development relating to prior year losses was \$25.4 million in 2005, \$30.5 million in 2004 and \$23.1 million in 2003, including \$26.0 million in 2005 and \$28.8 million in 2003 due to commutations, which primarily affected our discontinued line of business. The commutation losses primarily represent the discount for the time value of money on the reinsurance recoverables commuted. We reduced our net loss reserves on the 2004 hurricanes by \$7.2 million in 2005 to reflect current estimates of our remaining liabilities. In 2004 and 2005, as a result of adverse development of certain assumed accident and health business in our discontinued line of business, we strengthened our reserves for this line to bring them above our actuarial point estimate. See our discussion of factors that caused the deficiencies in the section covering gross losses above. Deficiencies and redundancies in reserves occur as a result of our continuing review and as losses are finally settled or claims exposures change. We have no material exposure to environmental or asbestos losses and believe we have provided for all material net incurred losses.

The following table provides comparative net loss ratios by line of business.

	2005		2004		2003	
	Net earned premium	Net loss ratio (As restated)	Net earned premium	Net loss ratio (As restated)	Net earned premium	Net loss ratio (As restated)
Diversified financial products	\$ 531,136	48.1%	\$ 310,809	47.6%	\$ 123,562	47.8%
Group life, accident and health	504,382	71.6	343,913	66.7	290,009	61.6
Aviation	136,197	67.3	127,248	63.2	97,536	61.5
London market account	93,017	106.0	111,341	65.9	137,572	52.8
Other specialty lines	97,721	72.6	69,089	63.5	12,443	62.1
Discontinued lines	7,535	551.3	48,292	145.2	77,150	142.6

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Totals	\$ 1,369,988	67.1%	\$ 1,010,692	63.8%	\$ 738,272	66.1%
Expense ratio		26.1		26.7		24.6
Combined ratio		93.2%		90.5%		90.7%

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Comments on significant changes in net loss ratios by line of business follow:

Group life, accident and health Rate pressure from competition as well as medical cost inflation have resulted in increasing loss ratios in this line of business, however our underwriting margins remain satisfactory.

Aviation The 2005 hurricanes increased the net loss ratio 5.0% and the 2004 hurricanes increased the net loss ratio 6.5%. The 2005 net loss ratio also includes the positive impact from the release of redundant reserves related to the 2004 hurricanes. Excluding the impact of the hurricanes, 2005 had worse than expected underwriting experience due to some unusually large international losses.

London market account The 2005 hurricanes increased the net loss ratio 63.2% and the 2004 hurricanes increased the net loss ratio 14.1%. The London market account line of business can have relatively high year-to-year volatility due to catastrophe exposure.

Other specialty lines The 2005 hurricanes increased the net loss ratio 14.0% and the 2004 hurricanes increased the net loss ratio 6.5%.

Discontinued lines The commutation losses in 2005 and 2003 affected the net loss ratios for those years. In addition, the 2005 and 2004 net loss ratios were impacted by loss reserve strengthening of \$8.9 million and \$27.3 million, respectively, on certain assumed accident and health reinsurance contracts.

Policy Acquisition Costs

Policy acquisition costs, which are net of the related portion of commissions on reinsurance ceded, increased to \$261.7 million in 2005 from \$222.3 million in 2004 and \$137.2 million in 2003. Policy acquisition costs as a percentage of net earned premium declined to 19.1% in 2005 from 22.0% in 2004 due to a change in the mix of business, reductions in commission rates on certain lines of business and our increased retentions, which increased our net earned premium at a higher rate than our non-commission acquisition costs. The expense ratio decreased in 2005 compared to 2004 for the same reasons. Policy acquisition costs as a percentage of net earned premium were 18.6% in 2003 and lower than 2004 due to changes in the mix of business.

Statutory

Regulatory guidelines suggest that a property and casualty insurer's annual statutory gross written premium should not exceed 900% of its statutory policyholders' surplus and net written premium should not exceed 300% of its statutory policyholders' surplus. However, industry standards and rating agency criteria place these ratios at 300% and 200%, respectively. Our property and casualty insurance companies have maintained premium to surplus ratios lower than such guidelines. For 2005, our statutory gross written premium to policyholders' surplus was 184.6% and our statutory net written premium to policyholders' surplus was 134.7%. At December 31, 2005, each of our domestic insurance companies' total adjusted capital was significantly in excess of the authorized control level risk-based capital level prescribed by the National Association of Insurance Commissioners.

Agency Segment

Revenue from our agency segment decreased to \$188.9 million in 2005 from \$226.8 million in 2004, primarily due to the consolidation of our largest underwriting agency into one of our life insurance companies effective January 1, 2005, less business produced in certain lines and the overall effect of ceding less reinsurance. As a result, segment net earnings also decreased in 2005 to \$38.5 million from \$53.6 million in 2004. While these actions resulted in less fee and commission income to our agency segment, they resulted in increased insurance company revenue and net earnings. Segment revenue increased 13% and net earnings increased 8% in 2004, primarily from increased new business and acquisitions. We expect the revenue and net earnings of this segment will decline slightly in 2006 due to continuing changes in the mix of business.

Table of Contents**Liquidity and Capital Resources***Cash Flow*

The restatement of previously issued financial statements discussed in Note 2 to our Consolidated Financial Statements had no impact on our reported net cash flows.

We receive substantial cash from premiums, reinsurance recoverables, commutations, fee and commission income, proceeds from sales and redemptions of investments and investment income. Our principal cash outflows are for the payment of claims and loss adjustment expenses, premium payments to reinsurers, purchases of investments, debt service, policy acquisition costs, operating expenses, taxes and dividends.

Cash provided by operating activities can fluctuate due to timing differences in the collection of premiums and reinsurance recoverables and the payment of losses and premium and reinsurance balances payable, the completion of commutations and activity in our trading portfolio. Our cash provided by operating activities has been strong in recent years due to: 1) our increasing net earnings, 2) growth in net written premium and net loss reserves due to organic growth and increased retentions, 3) commutations of selected reinsurance agreements and 4) expansion of our diversified financial products line of business as a result of which we retain premium longer due to the longer duration of claims liabilities.

The components of our net operating cash flows are detailed in the following table.

	2005 (As restated)	2004 (As restated)	2003 (As restated)
Net earnings	\$ 191,192	\$ 162,699	\$ 142,027
Change in premium, claims and other receivables, net of reinsurance, other payables and restricted cash	(59,717)	237	(26,513)
Change in unearned premium, net	121,242	104,895	133,894
Change in loss and loss adjustment expense payable, net of reinsurance recoverables	454,859	349,813	262,818
Gain on sale of subsidiaries	(8,717)	(6,317)	(52,681)
Change in trading portfolio	(66,809)	25,673	12,741
Other, net	(8,060)	31,703	55,812
Cash provided by operating activities	\$ 623,990	\$ 668,703	\$ 528,098

Cash provided by operating activities decreased \$44.7 million in 2005 and increased \$140.6 million in 2004. Cash received from commutations, included in cash provided by operating activities, totaled \$180.8 million, \$79.5 million and \$49.0 million in 2005, 2004 and 2003, respectively. Excluding the commutations, cash provided by operating activities decreased \$146.0 million in 2005 compared to an increase of \$110.1 million in 2004. The decrease in 2005 was principally due to an increase in paid claims in 2005 as a result of payments of 2004 hurricane losses and claims related to business commuted in 2004, the timing of receipt of premiums and payment of payables, and the effect of our trading portfolio activity. Cash flows increased in 2004 principally due to increasing retentions, the growth of our diversified financial products line of business and an increase in earnings from continuing operations, net of a \$21.0 million tax payment in 2004 on the 2003 gain on the sale of a subsidiary. Cash flows are expected to be strong again in 2006.

Table of Contents*Investments*

At December 31, 2005, we had \$3.3 billion of investment assets, an increase of \$788.9 million from the end of 2004. The increase resulted from strong operating cash flows and our \$150.0 million common stock offering. The majority of our investment assets are held by our insurance companies. All of our fixed income securities are classified as available for sale and are recorded at market value.

Our investment policy is determined by our Board of Directors and our Investment and Finance Committee and is reviewed on a regular basis. Our policy for each of our insurance company subsidiaries must comply with applicable State and Federal regulations which prescribe the type, quality and concentration of investments. These regulations permit investments, within specified limits and subject to certain qualifications, in federal, state and municipal obligations, obligations of foreign countries, corporate bonds and preferred and common equity securities. The regulations generally allow certain other types of investments subject to maximum limitations.

We engage independent investment advisors to oversee our fixed income investments and to make investment recommendations. We invest our funds principally in highly rated fixed income securities. Our historical investment strategy is to maximize interest income and yield, rather than to maximize total return. In accordance with our strategy, realized gains and losses from sales of investment securities are usually minimal, unless we decide to capture gains to enhance statutory capital and surplus of our insurance company subsidiaries. Although we generally intend to hold fixed income securities to maturity, we regularly re-evaluate our position based on market conditions. Our portfolio turnover will fluctuate, depending upon opportunities to increase yields by replacing one security with another higher yielding security.

At December 31, 2005, we had cash and short-term investments of \$913.5 million, of which \$589.2 million is held by our insurance companies. We maintain cash and liquid short-term instruments in our insurance companies in order to be able to fund losses of our insureds. Cash and short-term investments were higher than normal at December 31, 2005 and 2004 due to proceeds from common stock offerings and commutations that were consummated close to each year end. Those proceeds had not yet been invested on a longer term basis.

This table shows a profile of our fixed income and short-term investments. The table shows the average amount of investments, income earned and the yield thereon.

	2005	2004	2003
Average investments, at cost	\$ 2,822,686	\$ 2,054,620	\$ 1,403,690
Net investment income *	98,851	64,885	47,335
Average short-term yield *	2.7%	1.7%	1.8%
Average long-term yield *	4.0%	3.9%	4.2%
Average long-term tax equivalent yield *	4.9%	4.8%	5.0%
Weighted average combined tax equivalent yield *	4.1%	3.8%	3.8%
Weighted average maturity	7.6years	6.6years	4.5years
Weighted average duration	4.9years	4.6years	3.7years
Average S&P rating	AAA	AAA	AA+

* Excluding realized and unrealized investment gains and losses.

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This table summarizes the estimated market value of our investments by type at December 31, 2005.

	Amount	%
Short-term investments	\$ 839,581	26%
U.S. government	89,724	3
States, municipalities and political subdivisions	418,873	13
Special revenue fixed income securities	723,101	22
Corporate fixed income securities	375,582	11
Asset-backed and mortgage-backed securities	355,372	11
Foreign securities	305,972	9
Other investments	149,223	5
Total investments	\$ 3,257,428	100%

This table summarizes, by rating, the market value of our investments in fixed income securities at December 31, 2005.

	Amount	%
AAA	\$ 1,593,663	70%
AA	273,714	12
A	390,074	17
BBB	10,526	1
BB and below	647	
Total fixed income securities	\$ 2,268,624	100%

This table indicates the expected maturity distribution of the estimated market value of our fixed income securities at December 31, 2005.

	Amount	%
One year or less	\$ 146,924	6%
One year to five years	561,240	25
Five years to ten years	467,542	21
Ten years to fifteen years	301,264	13
More than fifteen years	436,282	19
Securities with fixed maturities	1,913,252	84
Asset-backed and mortgage-backed securities	355,372	16
Total fixed income securities	\$ 2,268,624	100%

The weighted average life of our asset-backed and mortgage-backed securities is 2.6 years.

The market value of our fixed income securities is sensitive to changing interest rates. As interest rates increase, the market value will generally decrease and as rates decrease, the market value will generally increase. The fluctuations in market value are somewhat muted by the relatively short duration of our portfolio and our relatively high level of investments in state and municipal obligations. During 2005, the net pre-tax unrealized gain on our fixed income securities decreased \$29.3 million due to market value changes. We estimate that a 1% increase in interest rates would decrease the market value of our fixed income securities by approximately \$111.2 million and a 1% decrease would increase the market value by a like amount. Fluctuations in interest rates have a minimal effect on the value of our

short-term investments due to their very short maturities. In our current position, higher interest rates would have a positive effect on net earnings.

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Some of our fixed income securities have call or prepayment options. This could subject us to reinvestment risk should interest rates fall or issuers call their securities and we reinvest the proceeds at lower interest rates. We mitigate this risk by investing in securities with varied maturity dates, so that only a portion of our portfolio will mature at any point in time.

The average duration of claims in many of our lines of business is relatively short and, accordingly, our investment portfolio had a relatively short duration. In recent years we have expanded the directors' and officers' liability and professional indemnity components of our diversified financial products line of business, which have a longer claims duration than our other lines of business. We are taking these changes into consideration in determining the duration of our investment portfolio. We have also kept the duration of our portfolio relatively short in recent years when rates were very low, in expectation of higher interest rates. We have recently extended the duration and maturities of our investments to take advantage of higher long-term market interest rates.

The following table compares our insurance company subsidiaries' cash and investment maturities with their estimated future claims payments at December 31, 2005.

	Total	Maturities / Estimated payment dates			
		2006	2007-2008	2009-2010	Thereafter
Cash and investment maturities of insurance companies	\$ 2,969,277	\$ 897,421	\$ 469,980	\$ 380,460	\$ 1,221,416
Estimated loss and loss adjustment expense payments, net of reinsurance	1,533,433	537,968	552,721	259,741	183,003
Estimated available cash flow	\$ 1,435,844	\$ 359,453	\$ (82,741)	\$ 120,719	\$ 1,038,413

As demonstrated in the above table, we maintain sufficient liquidity to pay anticipated policyholder claims on their expected payment dates. In addition, we can use current operating cash flow to pay claims as they become due. We manage the liquidity of our insurance company subsidiaries such that each subsidiary's anticipated claims payments will be met by its own current operating cash flows, cash, short-term investments or investment maturities. We do not foresee the need to sell securities prior to their maturity to fund claims payments, nor do we anticipate needing to use our \$200.0 million Revolving Loan Facility to pay claims. However, this credit facility can provide additional short-term liquidity if an unexpected event was to occur.

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The following table presents a summary of our total contractual cash payment obligations by estimated payment date at December 31, 2005.

	Total	2006	Estimated Payment Dates		
			2007-2008	2009-2010	Thereafter
Gross loss and loss adjustment expense payable (1)					
Diversified financial products	\$ 953,131	\$ 199,984	\$ 388,204	\$ 238,847	\$ 126,096
Group life, accident and health	204,100	169,698	26,734	6,077	1,591
Aviation	193,242	95,036	65,946	21,309	10,951
London market account	578,253	239,558	284,154	48,084	6,457
Other specialty lines	195,918	93,245	75,064	22,276	5,333
Discontinued lines	689,076	146,469	222,988	122,863	196,756
Total loss and loss adjustment expense payable	2,813,720	943,990	1,063,090	459,456	347,184
Life and annuity policy benefits	73,415	1,859	3,577	3,397	64,582
1.30% Convertible Notes (2) (3)	125,812	125,812			
2.00% Convertible Exchange Notes (2) (3)	174,120	174,120			
Other notes payable (3)	13,899	1,003	11,753	508	635
\$200.0 million Revolving Loan Facility					
Operating leases	59,123	10,582	18,936	12,150	17,455
Earnout liabilities	32,318	32,318			
Indemnifications	20,748	13,294	1,968	2,172	3,314
Total obligations	\$ 3,313,155	\$ 1,302,978	\$ 1,099,324	\$ 477,683	\$ 433,170

In preparing the previous table, we made the following estimates and assumptions.

- (1) The estimated loss and loss adjustment expense payments for future periods assume that the percentage of ultimate losses paid from one period to the next will be relatively consistent over time. Actual payments will be influenced by many factors and could vary from the estimated amounts above.
- (2) The 1.30% Convertible Notes mature in 2023 and the 2.00% Convertible Exchange Notes mature in 2021, but are shown in the 2006 column since they may be surrendered for cash at the option of the holders in the first quarter of 2006 because our stock traded at specified price levels in 2005. Both convertible notes have various put and redemption dates as disclosed in Note 6 to the Consolidated Financial Statements.

- (3) Amounts include interest payable in respective periods.

The purchase agreements for two of our acquisitions provide for earnout payments. The above table includes the amounts earned in 2005, which are payable in 2006.

In conjunction with the sales of business assets and subsidiaries, we have provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to our responsibilities to perform under the sales contracts. Other indemnifications agree to reimburse the purchasers for taxes or ERISA-related amounts, if any, assessed after the sale date but related to pre-sale activities. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such

indemnification expires on December 31, 2009.

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We accrue a loss related to our indemnifications when a valid claim is made by a buyer and we believe we have potential exposure. We currently have several claims under indemnifications that cover certain net losses alleged to have been incurred in periods prior to our sale of certain subsidiaries or otherwise alleged to be covered under indemnification agreements related to such sales. As of December 31, 2005, we have recorded a liability of \$20.7 million and have provided \$8.1 million of letters of credit to cover our obligations or anticipated payments under these indemnifications.

Subsidiary Dividends

The principal assets of HCC are the shares of capital stock of its insurance company subsidiaries. Historically, we have not relied on dividends from our insurance companies to meet the parent holding company's obligations, which are primarily outstanding debt and debt service obligations, dividends to shareholders and corporate expenses, since we have had sufficient cash flow from our agencies and intermediaries to meet our corporate cash flow requirements. However, as more profit is now expected to be earned in our insurance companies, we may have to partially depend on cash flow from our insurance companies in the future.

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. HCC's direct domestic insurance company subsidiaries can pay an aggregate of \$90.3 million in dividends in 2006 without obtaining special permission from state regulatory authorities. In 2005 and 2004, one insurance company subsidiary paid HCC a dividend of \$50.0 million and \$20.0 million, respectively. The funds were then contributed to another insurance company subsidiary.

Lines of Credit

Our \$200.0 million Revolving Loan Facility allows us to borrow up to the maximum allowed by the facility on a revolving basis until the facility expires on November 30, 2009. The facility is collateralized in part by the pledge of our insurance companies' stock and guarantees entered into by our underwriting agencies and reinsurance brokers. The facility agreement contains certain restrictive covenants, which we believe are typical for similar financing arrangements. We had no borrowings under this facility at December 31, 2005.

In 2006, we entered into a \$34.0 million Standby Letter of Credit Facility, which allows us to replace a portion of our funds at Lloyd's of London with standby letters of credit. Any letters of credit issued under the Standby Letter of Credit Facility will be unsecured commitments of HCC. The Standby Letter of Credit Facility contains standard restrictive covenants, which in many cases are identical to or incorporate by reference the restrictive covenants from our Revolving Loan Facility.

At December 31, 2005, certain of our subsidiaries maintained revolving lines of credit with a bank in the combined maximum amount of \$45.2 million available through November 30, 2009. Advances under the lines of credit are limited to amounts required to fund draws, if any, on letters of credit issued by the bank on behalf of the subsidiaries and short-term direct cash advances. The lines of credit are collateralized by securities having an aggregate market value of up to \$56.5 million, the actual amount of collateral at any one time being 125% of the aggregate amount outstanding. Interest on the lines is payable at the bank's prime rate of interest (7.25% at December 31, 2005) for draws on the letters of credit and either prime or prime less 1% on short-term cash advances. At December 31, 2005, letters of credit totaling \$16.7 million had been issued to insurance companies by the bank on behalf of our subsidiaries, with total securities of \$20.9 million collateralizing the lines.

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Other

In May 2005, the Board of Directors declared a three-for-two stock split in the form of a 50% stock dividend on our shares of common stock, payable to shareholders of record on July 1, 2005. The distribution of the 35.1 million shares had no impact on our consolidated shareholders' equity, results of operations or cash flows.

In the second quarter of 2006, we filed a Universal Shelf registration statement with the Securities and Exchange Commission, which replaced our previously filed registration statements and provides for the issuance of an aggregate of \$1.0 billion of our securities. These securities may be debt securities, equity securities, trust preferred securities, or a combination thereof. We sold 4.7 million and 4.5 million shares of our common stock at prices of \$32.05 and \$22.17 per share in 2005 and 2004, respectively, under this shelf registration. Net proceeds of \$150.0 million in 2005 were used to make \$108.0 million of capital contributions to our insurance company subsidiaries and to fund acquisitions. We used the net proceeds of \$96.7 million in 2004 to make a \$75.0 million capital contribution to an insurance company subsidiary and \$17.0 million to pay down bank debt.

As a result of our delayed filing of our Form 10-Q's for the quarters ended June 30, 2006 and September 30, 2006, we are ineligible to register our securities on Form S-3 or use our previously filed shelf registration statement until we have timely filed all periodic reports under the Securities Exchange Act of 1934 for one year. We may use Form S-1 to raise capital and borrow money utilizing public debt or complete acquisitions of other companies, which could increase transaction costs and adversely impact our ability to raise capital and borrow money or complete acquisitions in a timely manner. In addition, the financial strength ratings of our insurance companies and our debt ratings, which A.M. Best placed under review with negative implications and Fitch Ratings and Standard & Poor's affirmed with a stable outlook, if reduced, might significantly impede our ability to raise capital and borrow money.

On October 30, 2006, we received a registered letter from U.S. Bank, as trustee for the holders of our 2.00% Convertible Notes due 2021, 1.30% Convertible Notes due 2023 and 2.00% Convertible Exchange Notes due 2021, stating that U.S. Bank, as trustee, had not received our consolidated financial statements for the quarter ended June 30, 2006. If we do not file our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 with the SEC and deliver the report to the trustee within sixty days from the date notice was received from the trustee, such failure to file and deliver will be considered an Event of Default under the indenture governing the notes. If an Event of Default were to occur under the indentures for any series of the notes, the trustee or holders of at least 25% of the aggregate principal of such series then outstanding could declare all the unpaid principal on such series of notes then outstanding to be immediately due and payable. Likewise, we have not timely delivered our Form 10-Q's for the quarters ended June 30 and September 30, 2006 as required by the terms of our Revolving Loan Facility. The banks that are a party to the agreement waived certain Defaults or Events of Default until January 31, 2007. In addition, our restatement of our prior year financial statements might be considered an Event of Default, which has been waived until January 31, 2007 under our Revolving Loan Facility. Our failure to comply with the covenants in the indentures for our convertible notes and our Revolving Loan Facility in the future could have a material adverse effect on our stock price, business and financial condition if we would not have available funds at that time to repay any defaulted debt. A default and acceleration under the indentures for our convertible notes and loan agreement may also trigger cross-acceleration under our other debt instruments.

In December 2006, our existing Revolving Loan Facility was increased by \$100.0 million to \$300.0 million. Pursuant to the terms of the agreement, the Company can borrow up to \$25 million in addition to what is currently borrowed for working capital purposes. However, the full unfunded amount of the facility would be available to pay any potential convertible note conversion or put.

As described in Note 2 to our Consolidated Financial Statements included in this Form 10-K/A, based on the Special Committee's voluntary independent investigation of our past practices related to granting stock options, we determined that the price on the actual measurement date for a number of our stock option grants during the period 1997 through 2005 and into 2006 did not correspond to the price on the stated grant date and that certain option grants were retroactively priced. The investigation was conducted with the help of a law firm that was not previously involved with our stock option plans and procedures. The SEC has commenced an informal inquiry. In connection with its inquiry, we received a document request from the SEC. We intend to fully cooperate with the informal inquiry. We are unable to predict the outcome of or the future costs related to the informal inquiry.

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Our debt to total capital ratio was 15.5% at December 31, 2005 and 19.0% at December 31, 2004.

We believe that our operating cash flows, investments, Revolving Loan Facility and other sources of liquidity are sufficient to meet our operating needs for the foreseeable future.

Impact of Inflation

Our operations, like those of other property and casualty insurers, are susceptible to the effects of inflation, as premiums are established before the ultimate amounts of loss and loss adjustment expense are known. Although we consider the potential effects of inflation when setting premium rates, for competitive reasons, such premiums may not fully offset the effects of inflation. However, because the majority of our business is comprised of lines which have relatively short lead times between the occurrence of an insured event, reporting of the claims to us and the final settlement of the claims or have claims that are not significantly impacted by inflation, the effects of inflation are minimized.

A portion of our revenue is related to healthcare insurance and reinsurance products that are subject to the effects of the underlying inflation of healthcare costs. Such inflation in the costs of healthcare tends to generate increases in premiums for medical stop-loss coverage, resulting in greater revenue but also higher claim payments. Inflation also may have a negative impact on insurance and reinsurance operations by causing higher claim settlements than may originally have been estimated, without an immediate increase in premiums to a level necessary to maintain profit margins. We do not specifically provide for inflation when setting underwriting terms and claim reserves, although we do consider trends. We continually review claim reserves to assess their adequacy and make necessary adjustments. Inflation can also affect interest rates. Any significant increase in interest rates could have a material adverse effect on the market value of our investments. In addition, the interest rate payable under our Revolving Loan Facility fluctuates with market interest rates. Any significant increase in interest rates could have a material adverse effect on our net earnings, depending on the amount borrowed on that facility.

Foreign Exchange Rate Fluctuations

We underwrite risks which are denominated in a number of foreign currencies. As a result, we have receivables and payables in foreign currencies and we establish and maintain loss reserves with respect to our insurance policies in their respective currencies. Our net earnings could be impacted by exchange rate fluctuations affecting these balances. Our principal area of exposure is related to fluctuations in the exchange rates between the British pound sterling, the Euro and the U.S. dollar. We constantly monitor the balance between our receivables and payables and loss reserves to mitigate the potential exposure should an imbalance be expected to exist for other than a short period of time. Our gain (loss) from currency conversion was \$(1.0) million in 2005 compared to \$1.2 million in 2004 and \$3.7 million in 2003. Included in the 2003 amount was a one-time gain of \$1.3 million from the settlement of an advance of funds to an unaffiliated entity.

Critical Accounting Policies

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) requires us to make estimates and assumptions when applying our accounting policies. The following sections provide information about our estimation processes related to certain of our critical accounting policies.

Loss and Loss Adjustment Expense

Our net loss and loss adjustment expense reserves are composed of reserves for reported losses and reserves for incurred but not reported losses, less a reduction for reinsurance recoverables related to those reserves. Reserves are recorded by product line and are undiscounted, except for reserves related to acquisitions.

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The process of estimating our loss and loss adjustment expense reserves involves a considerable degree of judgment by management and is inherently uncertain. The recorded reserves represent management's best estimate of unpaid loss and loss adjustment expense by line of business. Because we provide insurance coverage in specialized lines of business that often lack statistical stability, management considers many factors, and not just the actuarial point estimates discussed below, in determining ultimate expected losses and the level of net reserves required and recorded.

To record reserves on our lines of business, we utilize expected loss ratios, which management selects based on the following: 1) information used to price the applicable policies, 2) historical loss information where available, 3) any public industry data for that line or similar lines of business and 4) an assessment of current market conditions. Management also considers the point estimates and ranges calculated by our actuaries, together with input from our experienced underwriting and claims personnel. Because of the nature and complexities of the specialized types of business we insure, management may give greater weight to the expectations of our underwriting and claims personnel, who often perform a claim by claim review, rather than to the actuarial estimates. However, we utilize the actuarial point and range estimates to monitor the adequacy and reasonableness of our recorded reserves.

Each quarter-end, management compares recorded reserves to the most recent actuarial point estimate and range for each line of business. If the recorded reserves vary significantly from the actuarial point estimate, management determines the reasons for the variances and may adjust the reserves up or down to an amount that, in management's judgment, is adequate based on all of the facts and circumstances considered, including the actuarial point estimates. Generally, we maintain total consolidated net reserves above the total actuarial point estimate but within the actuarial range.

The table below shows our recorded net reserves at December 31, 2005 by line of business, the actuarial reserve point estimates, and the high and low ends of the actuarial reserve range as determined by our reserving actuaries.

	Recorded net reserves	Actuarial point estimate	Low end of actuarial range	High end of actuarial range
Total net reserves	\$ 1,533,433	\$ 1,509,149	\$ 1,418,139	\$ 1,647,937
Individual lines of business:				
Diversified financial products	\$ 551,350	\$ 548,060	\$ 477,296	\$ 644,673
Group life, accident and health	162,076	165,545	151,301	181,882
Aviation	104,727	97,998	91,060	106,615
London market account	197,142	192,228	182,571	217,638
Other specialty lines	105,020	98,112	92,944	108,997
Discontinued lines	413,118	407,206	358,389	490,719
Total net reserves	\$ 1,533,433			

The actuarial point estimates represent our actuaries' estimate of the most likely amount that will ultimately be paid to settle the net reserves we have recorded at a particular point in time. While, from an actuarial standpoint, a point estimate is considered the most likely amount to be paid, there is inherent uncertainty in the point estimate, and it can be thought of as the expected value in a distribution of possible reserve estimates. The actuarial ranges represent our actuaries' estimate of a likely lowest amount and highest amount that will ultimately be paid to settle the net reserves we have recorded at a particular point in time. While there is still a possibility of ultimately paying an amount below the range or above the range, the actuarial probability is very small. The range determinations are based on estimates and actuarial judgments and are intended to encompass reasonably likely changes in one or more of the variables that were used to determine the point estimates.

The low end of the actuarial range and the high end of the actuarial range for the total net reserves will not equal the sum of the low and high ends for the individual lines of business. Moreover, in actuarial terms, it would not be appropriate to add the ranges for each line of business to obtain a range around the total net reserves because this would not reflect the diversification effects across our various lines of business. The diversification effects result from the fact that losses across the different lines of business are not completely correlated.

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In actuarial practice, some of our lines of business are more effectively modeled by a statistical distribution that is skewed or non-symmetric. These distributions are usually skewed towards large losses, which causes the midpoint of the range to be above the actuarial point estimate or mean value of the range. This should be kept in mind when using the midpoint as a proxy for the mean. Our assumptions, estimates and judgments can change based on new information and changes in conditions and, if they change, it will affect the determination of the range amounts. The following table details the characteristics and major actuarial assumptions by major products within our lines of business utilized by our actuaries in the determination of actuarial point estimates and ranges. We considered all major lines of business written by the insurance industry when determining the relative characteristics of claims duration, speed of loss reporting and reserve volatility. Other companies may classify their own insurance products in different lines of business or utilize different actuarial assumptions.

Line of Business	Products	Underwriting	Duration	Claims Characteristics		Major actuarial assumptions
				Speed of loss reporting	Reserve volatility	
Diversified financial products	Directors and officers liability	Primary	Medium	Moderate	Medium	Historical and industry loss reporting patterns
	Professional indemnity	Primary	Medium	Moderate	Low	Historical loss reporting patterns
	Surety	Primary	Medium	Fast	Low	Historical loss payment and reporting patterns
Group life, accident and health	Medical stop-loss	Primary	Short	Fast	Low	Medical cost and utilization trends Historical loss payment and reporting patterns Rate changes
Aviation	Aviation	Primary and subscription	Medium	Fast	Medium	Historical loss payment and reporting patterns Rate changes
London market account	Accident and health	Primary and assumed	Medium to Long	Slow	High	Historical loss payment and reporting patterns
	Energy *	Subscription	Medium	Moderate	Medium	Historical loss payment and reporting patterns Historical severity and frequency Historical large loss experience
	Property *	Subscription	Medium	Moderate	Medium	

						Historical loss payment and reporting patterns Historical severity and frequency Historical large loss experience
Other specialty	Surplus lines business	Assumed	Medium	Moderate	Medium	Historical loss payment and reporting patterns
Discontinued	Accident and health reinsurance	Assumed	Long	Slow	High	Historical and industry loss payment and reporting patterns
*	Includes catastrophe losses					

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Assumed reinsurance represented 13% of our gross written premium in 2005 and 35% of our gross reserves at December 31, 2005. Approximately 55% of the assumed reinsurance reserves related to assumed accident and health business in our discontinued line, 20% related to assumed reinsurance in our London market account and 13% related to assumed reinsurance in our aviation and diversified financial products lines of business. The remaining assumed reinsurance reserves covered various minor reinsurance programs. The table above recaps the underwriting, claims characteristics and major actuarial assumptions for our assumed reinsurance business.

The assumed accident and health business is primarily reinsurance that provides excess coverage for large losses related to workers' compensation policies. As discussed previously, we recorded \$8.9 million of adverse development, net of reinsurance, in 2005 and \$27.3 million in 2004. These losses resulted from late reporting of claims by cedants and state guaranty associations and changes in our actuarial assumptions related to this business. To mitigate our exposure to unexpected losses reported by cedants, our claims personnel review reported losses to ensure they are reasonable and consistent with our expectations. In addition, our claims personnel periodically audit the cedants' claims processing functions to assess whether cedants are submitting timely and accurate claims reports to us.

Disputes with insureds related to claims or coverage issues are administered in the normal course of business or settled through arbitration. Based on the negative factors we experienced in the past two years and the higher risk of this discontinued line of business relative to our continuing lines of business, management believes there may be a greater likelihood of future adverse development in this assumed accident and health business than in our other lines of business. We periodically reassess loss reserves for this assumed business and adjust them, if needed. We are pursuing commutations with certain cedants to limit our future exposure to unanticipated losses from this business. The majority of the assumed reinsurance in our London market account, aviation and diversified financial products lines of business is facultative reinsurance. This business involves reinsurance of a company's entire captive insurance program or business that must be written through another insurance company licensed to write insurance in a particular country or locality. In all cases, we underwrite the business and administer the claims, which are reported without a lag by the brokers. Disputes, if any, generally relate to claims or coverage issues with insureds and are administered in the normal course of business. We establish loss reserves for this assumed reinsurance using the same methods and assumptions we use to set reserves for comparable primary business.

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The following tables show the composition of our gross, ceded and net reserves at the respective balance sheet dates.

	Gross	Ceded (As restated)	Net (As restated)	% Net IBNR to net total reserves
At December 31, 2005				
Reported loss reserves:				
Diversified financial products	\$ 319,000	\$ 126,665	\$ 192,335	
Group life, accident and health	129,601	6,366	123,235	
Aviation	118,122	55,602	62,520	
London market account	345,605	260,473	85,132	
Other specialty lines	51,634	27,590	24,044	
Subtotal reported reserves	963,962	476,696	487,266	
Incurred but not reported reserves:				
Diversified financial products	634,131	275,116	359,015	65%
Group life, accident and health	74,499	35,658	38,841	24
Aviation	75,120	32,913	42,207	40
London market account	232,648	120,638	112,010	57
Other specialty lines	144,284	63,308	80,976	77
Subtotal incurred but not reported reserves	1,160,682	527,633	633,049	57
Discontinued lines reported reserves	437,681	159,529	278,152	
Discontinued lines incurred but not reported reserves	251,395	116,429	134,966	33
Total loss and loss adjustment expense payable	\$ 2,813,720	\$ 1,280,287	\$ 1,533,433	50%

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	Gross	Ceded	Net	% Net IBNR to net total reserves
At December 31, 2004				
Reported loss reserves:				
Diversified financial products	\$ 149,448	\$ 64,852	\$ 84,596	
Group life, accident and health	128,973	31,235	97,738	
Aviation	108,277	48,301	59,976	
London market account	182,585	106,249	76,336	
Other specialty lines	26,717	14,349	12,368	
Subtotal reported reserves	596,000	264,986	331,014	
Incurred but not reported reserves:				
Diversified financial products	462,795	257,853	204,942	71%
Group life, accident and health	90,396	30,131	60,265	38
Aviation	55,169	24,117	31,052	34
London market account	98,530	31,090	67,440	47
Other specialty lines	62,206	28,930	33,276	73
Subtotal incurred but not reported reserves	769,096	372,121	396,975	55
Discontinued lines reported reserves	453,394	241,481	211,913	
Discontinued lines incurred but not reported reserves	270,709	151,328	119,381	36
Total loss and loss adjustment expense payable	\$ 2,089,199	\$ 1,029,916	\$ 1,059,283	49%

We determine our incurred but not reported reserves by first projecting the ultimate expected losses by product within each line of business. We then subtract paid losses and reported loss reserves from the ultimate loss reserves. The remainder is our incurred but not reported reserves. The level of incurred but not reported reserves in relation to total reserves depends upon the characteristics of the particular line of business, particularly with respect to the speed by which losses are reported and outstanding claims reserves are adjusted. Lines for which losses are reported fast will have a lower percentage incurred but not reported reserve than slower reporting lines, and lines for which reserve volatility is low will have a lower percentage incurred but not reported loss reserve than high volatility lines. The reserves for reported losses related to our primary business and certain reinsurance assumed are initially set by our claims personnel or independent claims adjusters we retain. The reserves are subject to our review, with a goal of setting them at the ultimate expected loss amount as soon as possible when the information becomes available. Reserves for reported losses related to other reinsurance assumed are recorded based on information supplied to us by the ceding company. Our claims personnel monitor these reinsurance assumed reserves on a current basis and audit ceding companies' claims to ascertain that claims are being recorded currently and that net reserves are being set at levels that properly reflect the liability related to the claims.

The percentage of net incurred but not reported reserves to net total reserves increased slightly from 49% at December 31, 2004 to 50% at December 31, 2005. The reasons for the significant changes in net reserves by line of business follow:

Diversified financial products Total net reserves in our diversified financial products line of business increased \$261.8 million from 2004 to 2005 as this relatively new line of business continues to grow. The incurred but not reported portion of the total reserves for this line of business is higher than in most of our other lines, since these losses report slower and have a longer duration.

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Group life, accident and health Incurred but not reported reserves have decreased and reported reserves have increased due to a speed up in the reporting of medical stop-loss claims.

London market account Total net reserves in our London market account increased \$53.4 million and the percentage of incurred but not reported reserves increased in 2005, due to estimated unreported claims for the 2005 hurricanes.

Discontinued lines Total net reserves for our discontinued lines increased \$81.8 million in 2005 primarily as a result of a commutation. The percentage of net incurred but not reported reserves to total reserves for discontinued lines decreased to 33% as claims continued to be reported and reported reserves were reassessed.

With the exception of 2004 when we had negative development principally in the reserves related to our discontinued line of business, our net reserves historically have shown positive development except for the effects of losses on commutations, which we have completed in the past and may negotiate in the future. Commutations can produce negative 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 of the reserves; thus, the loss may be recouped as investment income is earned on the assets received. Based on our reserving techniques and our past results, we believe that our net reserves are adequate.

We have no material exposure to environmental pollution losses. Our largest insurance company subsidiary only began writing business in 1981 and its policies normally contain pollution exclusion clauses which limit pollution coverage to sudden and accidental losses only, thus excluding intentional dumping and seepage claims. Policies issued by our other insurance company subsidiaries do not have significant environmental exposures because of the types of risks covered. Therefore, we do not expect to experience any material loss development for environmental pollution claims. Likewise, we have no material exposure to asbestos claims.

Reinsurance Recoverables

Certain reinsurers have delayed or suspended payment of amounts recoverable under reinsurance contracts to which we are a party. We limit our liquidity exposure for uncollected recoverables by holding funds, letters of credit or other security, such that net balances due are significantly less than the gross balances shown in our consolidated balance sheets. We constantly monitor the collectibility of the reinsurance recoverables of our insurance companies and record a reserve for uncollectible reinsurance when we determine an amount is potentially uncollectible. Our evaluation is based on our periodic reviews of our disputed and aged recoverables, as well as our assessment of recoverables due from reinsurers known to be in financial difficulty. In some cases, we make estimates as to what portion of a recoverable may be uncollectible. Our estimates and judgment about the collectibility of the recoverables and the financial condition of reinsurers can change, and these changes can affect the level of reserve required.

The reserve was \$12.1 million at December 31, 2005, compared to \$20.4 million at December 31, 2004. We increased the reserve in 2005 by \$5.8 million to cover additional recoverables for which changed conditions caused us to believe that part or all of the outstanding balances may not be collectible. Amounts charged against the reserve in 2005 were \$5.0 million and in 2004 were immaterial. We also reclassified \$9.0 million to our liability for indemnifications during the year. We recently assessed the collectibility of our year-end recoverables related to our hurricane losses and believe amounts are collectible or adequately reserved based on currently available information.

We are currently in negotiations with most reinsurers who have delayed or suspended payments, but if such negotiations do not result in a satisfactory resolution, we may seek or be involved in litigation or arbitration. We resolved certain arbitrations in 2005; amounts with respect to the remaining arbitration and litigation proceedings that we initiated are not material.

Table of Contents*Deferred Taxes*

We recognize deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. We regularly review our deferred tax assets for recoverability and establish a valuation allowance based on our history of earnings, expectations for future earnings, taxable income in carry back years and the expected timing of the reversals of existing temporary differences. Although realization is not assured, we believe it is more likely than not that we will be able to realize the benefit of our deferred tax assets, with the exception of the benefit of certain pre-acquisition tax loss carryforwards for which valuation allowances have been provided. If there is a material change in the tax laws such that the actual effective tax rate changes or the time periods within which the underlying temporary differences become taxable or deductible change, we will need to reevaluate our assumptions, which could result in a change in the valuation allowance required.

Valuation of Goodwill

We assess the impairment of goodwill annually, or sooner if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. In determining the fair value of a reporting unit, we utilize the expected cash flow approach in Statement of Financial Accounting Concepts CON 7, *Using Cash Flow Information and Present Values in Accounting Measurements*. This approach utilizes a risk-free rate of interest, estimates of future cash flows and probabilities as to the occurrence of the future cash flows. We utilize our budgets and projection of future operations based on historical and expected industry trends to estimate our future cash flows and the probability of their occurring as projected. Based on our latest impairment test, the fair value of each of our reporting units exceeded its carrying amount by a satisfactory margin.

Other-Than-Temporary Impairments on Investments

Declines in the market value of invested assets below cost are evaluated for other-than-temporary impairment losses on a quarterly basis. Impairment losses for declines in value of fixed income securities below cost attributable to issuer-specific events are based on all relevant facts and circumstances for each investment and are recognized when appropriate. For fixed income securities with unrealized losses due to market conditions or industry-related events where we have the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary. At December 31, 2005, we had gross unrealized losses on fixed income securities of \$22.1 million (1.0% of aggregate market value) compared to \$5.1 million (0.3% of aggregate market value) at December 31, 2004.

Recent Accounting Pronouncements*Share-Based Payment*

The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, which requires companies to recognize the fair value of stock-based compensation with adoption required as of January 1, 2006. SFAS 123(R) allows either a prospective or retrospective adoption method. We will adopt SFAS 123(R) in 2006 using the modified prospective method, whereby results for prior periods will not be restated for the adoption of SFAS 123(R). Compensation expense recognized going forward will be based on our unvested stock options granted before January 1, 2006 and all options granted after that date. We will use the Black-Scholes option pricing model to determine the fair value of an option on its grant date and will expense that value over the option's vesting period. At December 31, 2005, there was approximately \$43.7 million of total unrecognized compensation expense related to unvested options that is expected to be recognized through 2010, of which we expect to recognize approximately \$13.6 million in 2006.

Had we adopted SFAS 123(R) in prior periods, the impact would have approximated the pro forma net income and earnings per share amounts calculated under SFAS 123, as disclosed in Note 1 to the Consolidated Financial Statements. The ultimate impact of adoption of SFAS 123(R) in future periods will depend on the following: 1) the amount and timing of options granted, exercised and forfeited, 2) the assumptions used to model fair value and 3) certain tax reporting requirements. We generally recognize a tax benefit when our employees exercise options. SFAS 123(R)

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requires that, in future periods, we report the benefit of tax deductions in excess of recognized compensation expense as a financing cash flow, rather than as an operating cash flow. We cannot estimate what the tax benefits or cash flow amounts will be in the future because they depend on a variety of factors, including when employees exercise stock options. However, we recognized operating cash flows of \$6.2 million, \$3.0 million and \$1.8 million in 2005, 2004 and 2003, respectively, for tax deductions associated with options exercised.

Other-Than-Temporary Impairments

The FASB has issued FASB Staff Position (FSP) No. 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The FSP requires recognition of an impairment loss on a debt security no later than when the investor deems the impairment is other-than-temporary, even if the investor has not decided to sell the security. This standard replaces current guidance in Emerging Issues Task Force Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The new standard is effective January 1, 2006. We expect that adoption of this FSP will have an immaterial impact on our consolidated financial position and results of operations.

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Accounting Changes and Corrections

The FASB has issued SFAS No. 154, *Accounting Changes and Error Corrections*, as a replacement of APB No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 requires restatement of all prior period financial statements if a company makes an accounting change or corrects an error. The standard is effective January 1, 2006. We will apply the standard, if applicable, in the future.

Uncertainty in Income Taxes

The FASB has issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*. Effective January 1, 2007, FIN 48 clarifies the accounting for uncertain income tax positions. We are currently reviewing the requirements of FIN 48 to determine the effect it will have on our consolidated financial statements.

Fair Value Measurements

The FASB has issued SFAS No. 157, *Fair Value Measurements*, which clarifies the definition of fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective January 1, 2008. We are currently assessing whether the adoption of SFAS 157 will have an impact on our consolidated financial statements.

Prior Year Misstatements

The Securities and Exchange Commission has issued Staff Accounting Bulletin (SAB) No.108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 establishes a standard approach for quantifying the materiality of errors to current and prior period financial statements. SAB 108's guidelines must be applied in the fourth quarter of 2006, and adjustments, if any, will be recorded either by restating prior year financial statements or recording a cumulative effect adjustment as of January 1, 2006. We believe the requirements of SAB 108 will have no effect on our consolidated financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our principal assets and liabilities are financial instruments which are subject to the market risk of potential losses from adverse changes in market rates and prices. Our primary market risk exposures are interest rate risk on fixed income securities and variable rate debt, and foreign currency exchange rate risk.

Caution should be used in evaluating overall market risk utilizing the information below. Actual results could differ materially from estimates below for a variety of reasons, including: 1) amounts and balances on which the estimates are based are likely to change over time, 2) assumptions used in the models may prove to be inaccurate, 3) market changes could be different from market changes assumed below and 4) not all factors and balances are taken into account.

Interest Rate Risk

To manage the exposures of our investment risks, we generally invest in investment grade securities with characteristics of duration and liquidity to reflect the underlying characteristics of the insurance liabilities of our insurance companies. We have not used derivatives to manage any of our investment related market risks. The value of our portfolio of fixed income securities is inversely correlated to changes in the market interest rates. In addition, some of our fixed income securities have call or prepayment options. This could subject us to reinvestment risk should interest rates fall or issuers call their securities and we reinvest the proceeds at lower interest rates. We attempt to mitigate this risk by investing in securities with varied maturity dates, so that only a portion of the portfolio will mature at any point in time.

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The fair value of our fixed income securities was \$2.3 billion at December 31, 2005 and \$1.7 billion at December 31, 2004. If market interest rates were to change 1% (e.g. from 5% to 6%), the fair value of our fixed income securities would have changed approximately \$111.2 million at December 31, 2005. This compares to a change in value of \$78.9 million at December 31, 2004 for the same 1% change in market interest rates. The change in fair value was determined using duration modeling assuming no prepayments.

Our \$200.0 million Revolving Loan Facility is subject to variable interest rates. Thus, our interest expense on this loan is directly correlated to market interest rates. At December 31, 2005 and 2004, there was no balance outstanding under this line of credit. Our 1.30% and 2.00% convertible notes are not subject to interest rate changes.

Foreign Exchange Risk

The table below shows the net amounts of significant foreign currency balances for subsidiaries with a U.S. dollar functional currency at December 31, 2005 and 2004 converted to U.S. dollars. It also shows the expected dollar change in fair value (in thousands) that would occur if exchange rates changed 10% from exchange rates in effect at those times.

	December 31,			
	2005	Hypothetical	2004	Hypothetical
	U.S. dollar equivalent	10% change in fair value	U.S. dollar equivalent	10% change in fair value
British pound sterling	\$ 11,590	\$ 1,159	\$ 6,163	\$ 616
Euro	2,291	229	2,117	212
Canadian dollar	522	52	2,537	254

See Foreign Exchange Rate Fluctuations section contained in Item 7, Management's Discussion and Analysis, and Note 1 in the Notes to Consolidated Financial Statements for additional information.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and financial statement schedules listed in the accompanying Index to Consolidated Financial Statements and Schedules are filed as part of this Report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None.

ITEM 9A. CONTROLS AND PROCEDURES**a. Disclosure Controls and Procedures*****Background of Restatement***

As disclosed in Explanatory Note Restatement of Consolidated Financial Statements on page 4 of this Form 10-K/A and in Note 2 to the Consolidated Financial Statements, in August 2006, our Board of Directors formed a Special Committee of independent directors to commence an investigation of our past stock option granting practices for the period 1995 through 2005. On November 17, 2006, we announced that the Special Committee found that we had used incorrect accounting measurement dates for stock option grants covering a significant number of employees and members of our Board of Directors during the period 1997 through 2005 and that certain option grants were retroactively priced. Additionally, at the direction of the Special Committee, we reviewed our stock option granting practices from 1992, the year of our initial public stock offering, through 1994 and in 2006 and found incorrect measurement dates due to retroactive pricing were used in 2006. In substantially all of these instances, the price on the actual measurement date was higher than the price on the stated grant date.

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The Special Committee concluded that mis-priced option grants, the effect of which, together with certain other adjustments, resulted in a cumulative net decrease in shareholders' equity at December 31, 2005 of \$3.3 million, affected all levels of employees. The Special Committee found that Stephen L. Way, Chief Executive Officer, retroactively priced options, that he should have known he was granting options in a manner that conflicted with our stock option plans and public statements, and that this constituted a failure to align the stock option granting process with our stock option plans and public statements. Although finding his actions were inconsistent with the duties and obligations of a chief executive officer of a publicly-traded company, the Special Committee also found that Mr. Way's motivation appeared to be the attraction and retention of talent and to provide employees with the best option price. The Special Committee also concluded that Christopher L. Martin, Executive Vice President and General Counsel, was aware that options were being retroactively priced in a manner inconsistent with applicable plan terms and the procedures memoranda that he had prepared, that granting in-the-money options had accounting implications, and that he did not properly document our Compensation Committee's informal delegation of authority to Mr. Way. The Special Committee also found that there was no evidence that Mr. Way or Mr. Martin intended to falsify the consolidated financial statements.

Before the Board of Directors reviewed the results of the investigation, the Chairman of our Compensation Committee tendered his resignation from the Board of Directors on November 8, 2006. After reviewing the results of the investigation, the Board of Directors determined that it would be appropriate to accept the resignations of Mr. Way and Mr. Martin, which both tendered on November 17, 2006.

We determined that, in accordance with Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*, and its related interpretations, we should have recorded compensation expense related to these mis-priced options for the excess of the market price of our stock on the actual accounting measurement date over the exercise price of the option. As a result, we concluded that we needed to amend this Annual Report on Form 10-K for the year ended December 31, 2005 to restate our consolidated financial statements and the related disclosures for the years ended December 31, 2005, 2004 and 2003 and the condensed consolidated financial statements for the quarter ended March 31, 2006 and all quarters for the years ended December 31, 2005 and 2004, and to record an adjustment to the condensed consolidated financial statements for the quarters ended June 30, 2006 and September 30, 2006. In addition, as discussed below, we concluded that we had a material weakness in our internal control over financial reporting as of December 31, 2005 and through the third quarter of 2006.

As part of the restatement process, we recorded other adjustments in the period 2000 through 2005 that were not recorded in the originally filed financial statements due to their immateriality. We evaluated the control deficiencies that resulted in these adjustments and concluded that these immaterial errors were the result of control deficiencies that did not constitute a material weakness, individually or in the aggregate, in our internal control over financial reporting.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Act)) that are designed to ensure that required information is recorded, processed, summarized and reported within the required timeframe, as specified in rules set forth by the Securities and Exchange Commission. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), to allow timely decisions regarding required disclosures.

At the time that our Annual Report on Form 10-K for the year ended December 31, 2005 was filed on March 16, 2006, our former CEO and our CFO concluded that our disclosure controls and procedures were effective as of December 31, 2005. Subsequent to that evaluation, our management, including our current CEO and our CFO, concluded that our disclosure controls and procedures were not effective as of December 31, 2005 because of the material weakness described below in Management's Report on Internal Control Over Financial Reporting (Restated). Notwithstanding this material weakness, our current management has concluded that our consolidated financial statements for the periods covered by and included in this Annual Report on Form 10-K/A are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and fairly present, in all material respects, our financial position, results of operations and cash flows for each of the periods presented herein.

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Management's Report on Internal Control Over Financial Reporting (Restated)

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Management, including our current CEO and our CFO, conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 based on the framework established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Our current management identified the following material weakness in our internal control over financial reporting as of December 31, 2005 and through the third quarter of 2006:

We did not maintain an effective control environment based on the criteria established in the COSO framework. We did not maintain adequate controls to prevent or detect management override by certain former members of senior management related to our stock option granting practices and procedures. This lack of an effective control environment permitted certain former members of senior management to override controls and retroactively price stock option grants, resulting in ineffective controls over our stock option granting practices and procedures. Effective controls, including monitoring and adequate communication, were not maintained to ensure the accuracy, valuation and presentation of activity related to our stock option granting practices and procedures. This control deficiency resulted in misstatement of our stock-based compensation expense, additional paid-in capital and related income tax accounts and related disclosures, and in the restatement of our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 and the condensed consolidated financial statements for the quarter ended March 31, 2006 and all quarters for the years ended December 31, 2005 and 2004, and the adjustment of the condensed consolidated financial statements for the quarters ended June 30, 2006 and September 30, 2006. This control deficiency could result in misstatement of the aforementioned accounts and disclosures that would result in a material misstatement of our annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, management has determined this control deficiency constitutes a material weakness.

In conducting our assessment, we excluded from our assessment the five companies that we acquired in purchase business combinations in 2005. These companies are wholly owned subsidiaries whose combined total assets and total revenue represented 3% and 1%, respectively, of the related consolidated financial statements as of and for the year ended December 31, 2005.

In Management's Report on Internal Control Over Financial Reporting included in our original Annual Report on Form 10-K for the year ended December 31, 2005, our former CEO and our CFO concluded that we maintained effective internal control over financial reporting as of December 31, 2005. Our current CEO and our CFO have subsequently concluded that the material weakness described above existed as of December 31, 2005 and through the third quarter of 2006. As a result, we have concluded that we did not maintain effective internal control over financial reporting as of December 31, 2005, based on the criteria in *Internal Control-Integrated Framework*. Accordingly, management has restated our report on internal control over financial reporting as of December 31, 2005 and our present opinion on internal control over financial reporting, as presented herein, is different from that expressed in our previous report.

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Our assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting during the last quarter of the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Remediation Plans

We are committed to remediating the material weakness identified above by implementing changes to our internal control over financial reporting to enhance our control environment. During 2006, we implemented or are in the process of implementing new policies and controls related to our stock option granting practices and procedures, as follows:

Before the Board of Directors reviewed the results of the investigation, the Chairman of our Compensation Committee tendered his resignation from the Board of Directors on November 8, 2006. After reviewing the results of the investigation, our Board of Directors determined that it would be appropriate to accept the resignations of our former CEO and General Counsel, which both tendered on November 17, 2006. Our Board of Directors has appointed a new Chairman of our Compensation Committee and a new CEO who, together with other members of our senior management, are committed to achieving transparency through effective corporate governance, a strong control environment, application of business standards reflected in our Code of Business Conduct and Ethics, and completeness and integrity of our financial reporting and disclosure.

We have changed our option granting approval policies and procedures to require Compensation Committee approval of all new option grants on the day of each Compensation Committee meeting preceding the regularly scheduled quarterly Board of Directors meeting. All grants will be appropriately approved and documented in minutes of the meeting, taken contemporaneously with the meeting. All grants will be priced at the market closing price on the day of each such Compensation Committee meeting. We have established processes and procedures to increase the level of communication between the Compensation Committee, senior management and our financial reporting and accounting personnel regarding stock option grants.

We are actively engaged in the implementation of other remediation efforts to address the material weakness identified in our internal control over financial reporting. Although we have not fully remediated the material weakness as of the date of this Form 10-K/A filing, we believe we have made substantial progress.

ITEM 9B. OTHER INFORMATION

We have disclosed all information required to be disclosed in a current report on Form 8-K during the fourth quarter of 2005 in previously filed reports on Form 8-K.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Code of Business Conduct and Ethics

We have adopted a Code of Business Conduct and Ethics which applies to all employees, officers and directors of our company. The complete text of our Code of Business Conduct and Code of Ethics is available on our website at www.hcc.com and will be provided to any person free of charge upon request made to: HCC Insurance Holdings, Inc., Investor Relations Department, 13403 Northwest Freeway, Houston, Texas 77040. Any amendments to, or waivers of, the Code of Business Conduct and Ethics which apply to the Chief Executive Officer and the Senior Financial Officers will be disclosed on our website.

For information regarding our Directors and Executive Officers, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2005 and which is incorporated herein by reference.

On June 10, 2005, we filed with the New York Stock Exchange the Annual CEO Certification regarding our compliance with the New York Stock Exchange's Corporate Governance listing standards as required by Section 303A-12(a) of the New York Stock Exchange Listed Company Manual. The Annual CEO Certification was issued without qualification. In addition, we have filed as exhibits to this report on Form 10-K and to the report on Form 10-K for the year ended December 31, 2004, the applicable certifications of our Chief Executive Officer and our Chief Financial Officer required under Section 302 of the Sarbanes-Oxley Act of 2002.

ITEM 11. EXECUTIVE COMPENSATION

For information regarding Executive Compensation, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2005 and which is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS

For information regarding Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2005 and which is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

For information regarding Certain Relationships and Related Transactions, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2005 and which is incorporated herein by reference.

Stephen L. Way has resigned as Chief Executive Officer effective November 17, 2006. Mr. Way will remain a director of HCC and serve as the non-executive Chairman of the Board of Directors. On November 17, 2006, HCC entered into a consulting agreement with Mr. Way to provide assistance to the Company's new CEO Frank J. Bramanti and guidance to HCC with respect to strategic planning (the Consulting Agreement). Under the terms of the Consulting Agreement, Mr. Way agreed to terminate his employment agreement with the loss of any further compensation including any 2006 bonus and, regarding options that Mr. Way had already exercised at any time, Mr. Way agreed to reimburse HCC for all gains or profit he received or obtained resulting from any difference between the exercise price at which Mr. Way exercised any option and the exercise price on the accurate grant date as determined by HCC with the concurrence of its independent auditors. In addition, with respect to unexercised vested options, Mr. Way also agreed that each new strike price would be based on the new measurement date as determined by HCC. Unvested options have been terminated.

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Christopher L. Martin has resigned as Executive Vice President and General Counsel effective November 17, 2006. On November 28, 2006, HCC entered into a Separation Agreement and Release with Mr. Martin effective as of November 17, 2006, pursuant to which Mr. Martin's employment agreement with HCC dated April 1, 2006, was terminated and, regarding options that Mr. Martin had already exercised at any time, Mr. Martin agreed to reimburse HCC for all gains or profit he received or obtained resulting from any difference between the exercise price at which Mr. Martin exercised any option and the exercise price on the accurate grant date as determined by HCC with the concurrence of its independent auditors. In addition, with respect to unexercised vested options, Mr. Martin also agreed that each new strike price will be based on the new measurement date as determined by HCC. Unvested options have been terminated.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

For information regarding Principal Accountant Fees and Services, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2005 and which is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Financial Statement Schedules

The restated financial statements and financial statement schedules listed in the accompanying Index to Consolidated Financial Statements and Schedules are filed as part of this Report.

(b) Exhibits

The exhibits listed on the accompanying Index to Exhibits are filed as part of this Report.

Table of Contents**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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)

Dated: December 26, 2006

By: /s/ FRANK J. BRAMANTI
(Frank J. Bramanti)
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ FRANK J. BRAMANTI (Frank J. Bramanti)	Director, Chief Executive Officer and Principal Executive Officer	December 26, 2006
/s/ PATRICK B. COLLINS* (Patrick B. Collins)	Director	December 26, 2006
/s/ JAMES R. CRANE* (James R. Crane)	Director	December 26, 2006
/s/ J. ROBERT DICKERSON* (J. Robert Dickerson)	Director	December 26, 2006
/s/ WALTER M. DUER* (Walter M. Duer)	Director	December 26, 2006
/s/ EDWARD H. ELLIS, JR. (Edward H. Ellis, Jr.)	Director, Executive Vice President and Chief Financial Officer (Chief Accounting Officer)	December 26, 2006
/s/ JAMES C. FLAGG, PH.D.* (James C. Flagg, Ph.D.)	Director	December 26, 2006
/s/ ALLAN W. FULKERSON* (Allan W. Fulkerson)	Director	December 26, 2006
/s/ JOHN N. MOLBECK, JR.* (John N. Molbeck, Jr.)	Director, President and Chief Operating Officer	December 26, 2006
/s/ MICHAEL A. F. ROBERTS* (Michael A. F. Roberts)	Director	December 26, 2006
 (Stephen L. Way)	Chairman of the Board, Director	

By: */s/ EDWARD H. ELLIS, JR.
Edward H. Ellis, Jr., Attorney-in-fact

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Schedules other than those listed above have been omitted because they are either not required, not applicable, or the required information is shown in the Consolidated Financial Statements and Notes thereto or other Schedules.	

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders

HCC Insurance Holdings, Inc.:

We have completed integrated audits of HCC Insurance Holdings, Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions on HCC Insurance Holdings Inc.'s 2005, 2004, and 2003 consolidated financial statements and on its internal control over financial reporting as of December 31, 2005, based on our audits, are presented below.

Consolidated financial statements and financial statement schedules

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of HCC Insurance Holdings, Inc. and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. As discussed in Note 2 to the consolidated financial statements, the Company has restated its 2005, 2004, and 2003 consolidated financial statements.

Internal control over financial reporting

Also, we have audited management's assessment, included in Management's Report on Internal Control over Financial Reporting (restated) appearing under Item 9A, that HCC Insurance Holdings, Inc. did not maintain effective internal control over financial reporting as of December 31, 2005, because of the effect of not maintaining an effective control environment, resulting in ineffective controls over stock option granting practices and procedures, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally

accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management's Report on Internal Control Over Financial Reporting, management has excluded from its assessment of internal control over financial reporting as of December 31, 2005 the five companies that it acquired in purchase business combinations in 2005. We have also excluded these five companies from our audit of internal control over financial reporting. These companies are wholly-owned subsidiaries whose combined total assets and total revenues represent 3% and 1%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2005.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment. As of December 31, 2005, management has concluded the Company did not maintain an effective control environment based on the

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criteria established in the COSO framework. The Company did not maintain adequate controls to prevent or detect management override by certain former members of senior management related to the Company's stock option granting practices and procedures. This lack of an effective control environment permitted certain former members of senior management to override controls and retroactively price stock option grants, resulting in ineffective controls over the Company's stock option granting practices and procedures. Effective controls, including monitoring and adequate communication, were not maintained to ensure the accuracy, valuation and presentation of activity related to the Company's stock option granting practices and procedures. This control deficiency resulted in misstatement of the Company's stock-based compensation expense, additional paid-in capital and related income tax accounts and related disclosures, and in the restatement of the Company's consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 and the condensed consolidated financial statements for the quarter ended March 31, 2006 and all quarters for the years ended December 31, 2005 and 2004, and the adjustment of the condensed consolidated financial statements for the quarters ended June 30, 2006 and September 30, 2006. This control deficiency could result in misstatement of the aforementioned accounts and disclosures that would result in a material misstatement of the Company's annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, management has determined this control deficiency constitutes a material weakness. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2005 consolidated financial statements, and our opinion regarding the effectiveness of the Company's internal control over financial reporting does not affect our opinion on those consolidated financial statements.

Management and we previously concluded that the Company maintained effective internal control over financial reporting as of December 31, 2005. However, management has subsequently determined that the material weakness described above existed as of December 31, 2005. Accordingly, Management's Report on Internal Control Over Financial Reporting has been restated and our present opinion on internal control over financial reporting, as presented herein, is different from that expressed in our previous report.

In our opinion, management's assessment that HCC Insurance Holdings, Inc. did not maintain effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. Also, in our opinion, because of the effects of the material weakness described above on the achievement of the objectives of the control criteria, HCC Insurance Holdings, Inc. has not maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO.

PricewaterhouseCoopers LLP
Houston, Texas

March 15, 2006, except for the restatement discussed in Note 2 to the consolidated financial statements and the matter discussed in the penultimate paragraph of Management's Report on Internal Control over Financial Reporting, as to which the date is December 22, 2006.

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HCC Insurance Holdings, Inc. and Subsidiaries
Consolidated Balance Sheets
(in thousands, except per share data)

	December 31,	
	2005 (As restated)	2004 (As restated)
ASSETS		
Investments:		
Fixed income securities, at fair value (amortized cost: 2005 - \$2,277,139; 2004 - \$1,682,421)	\$ 2,268,624	\$ 1,703,171
Short-term investments, at cost, which approximates fair value	839,581	729,985
Other investments, at fair value (cost: 2005 - \$144,897; 2004 - \$34,137)	149,223	35,335
 Total investments	 3,257,428	 2,468,491
Cash	73,935	69,933
Restricted cash and cash investments	170,978	188,510
Premium, claims and other receivables	884,654	891,360
Reinsurance recoverables	1,361,983	1,104,026
Ceded unearned premium	239,416	311,973
Ceded life and annuity benefits	73,415	74,627
Deferred policy acquisition costs	156,253	139,199
Goodwill	532,947	444,031
Other assets	277,791	208,418
 Total assets	 \$ 7,028,800	 \$ 5,900,568
 LIABILITIES		
Loss and loss adjustment expense payable	\$ 2,813,720	\$ 2,089,199
Life and annuity policy benefits	73,415	74,627
Reinsurance balances payable	176,954	217,938
Unearned premium	807,109	741,706
Deferred ceding commissions	67,886	93,480
Premium and claims payable	753,859	766,765
Notes payable	309,543	311,277
Accounts payable and accrued liabilities	335,879	280,078
 Total liabilities	 5,338,365	 4,575,070
 SHAREHOLDERS' EQUITY		
Common stock, \$1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2005 - 110,803; 2004 - 102,057)	110,803	68,038
Additional paid-in capital	762,170	582,566
Retained earnings	798,388	637,259
Accumulated other comprehensive income	19,074	37,635

Total shareholders' equity	1,690,435	1,325,498
Total liabilities and shareholders' equity	\$ 7,028,800	\$ 5,900,568

See Notes to Consolidated Financial Statements.

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

	Years ended December 31,		
	2005 (As restated)	2004 (As restated)	2003 (As restated)
REVENUE			
Net earned premium	\$ 1,369,988	\$ 1,010,692	\$ 738,272
Fee and commission income	132,628	183,802	142,615
Net investment income	98,851	64,885	47,335
Net realized investment gain	1,448	5,822	527
Other operating income	39,773	19,406	13,215
Total revenue	1,642,688	1,284,607	941,964
EXPENSE			
Loss and loss adjustment expense, net	919,697	645,230	488,000
Policy acquisition costs, net	261,708	222,323	137,212
Other operating expense	180,990	168,045	144,574
Interest expense	7,684	8,374	7,453
Total expense	1,370,079	1,043,972	777,239
Earnings from continuing operations before income tax expense	272,609	240,635	164,725
Income tax expense on continuing operations	84,177	81,940	59,382
Earnings from continuing operations	188,432	158,695	105,343
Earnings from discontinued operations, net of income taxes of \$1,686 in 2005, \$2,313 in 2004 and \$26,289 in 2003	2,760	4,004	36,684
Net earnings	\$ 191,192	\$ 162,699	\$ 142,027
Basic earnings per share data:			
Earnings from continuing operations	\$ 1.78	\$ 1.63	\$ 1.11
Earnings from discontinued operations	0.03	0.04	0.39
Net earnings	\$ 1.81	\$ 1.67	\$ 1.50
Weighted average shares outstanding	105,463	97,257	94,919
Diluted earnings per share data:			
Earnings from continuing operations	\$ 1.72	\$ 1.61	\$ 1.09
Earnings from discontinued operations	0.03	0.04	0.38
Net earnings	\$ 1.75	\$ 1.65	\$ 1.47

Weighted average shares outstanding	109,437	98,826	96,576
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See Notes to Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Consolidated Statements of Comprehensive Income
(in thousands)

	Years ended December 31,		
	2005	2004	2003
	(As	(As	(As
	restated)	restated)	restated)
Net earnings	\$ 191,192	\$ 162,699	\$ 142,027
Other comprehensive income (loss):			
Investment gains (losses):			
Investment gains (losses) during the year, net of income tax charge (benefit) of \$(2,946) in 2005, \$6,091 in 2004 and \$(1,048) in 2003	(4,257)	10,955	(1,962)
Less reclassification adjustment for gains included in net earnings, net of income tax charge of \$2,479 in 2005, \$2,433 in 2004 and \$184 in 2003	(4,605)	(4,518)	(343)
Foreign currency translation adjustment	(9,699)	6,287	6,451
Other comprehensive income (loss)	(18,561)	12,724	4,146
Comprehensive income	\$ 172,631	\$ 175,423	\$ 146,173

See Notes to Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
Years ended December 31, 2005, 2004 and 2003
(As restated)
(in thousands, except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total shareholders equity
Balance at December 31, 2002 As previously reported	\$ 62,358	\$ 416,406	\$ 383,378	\$ 20,765	\$ 882,907
Cumulative effect of restatement (Note 2)		13,861	(12,097)		1,764
Balance at December 31, 2002, as restated	62,358	430,267	371,281	20,765	884,671
Net earnings			142,027		142,027
Other comprehensive income				4,146	4,146
Issuance of 1,860 shares for exercise of options, including tax benefit of \$1,811	1,240	20,850			22,090
Issuance of 78 shares of contractually issuable stock	52	(52)			
Issuance of 472 shares for purchased company	314	7,958			8,272
Stock-based compensation		2,979			2,979
Cash dividends declared, \$0.187 per share			(17,780)		(17,780)
Balance at December 31, 2003	63,964	462,002	495,528	24,911	1,046,405
Net earnings			162,699		162,699
Other comprehensive income				12,724	12,724
Issuance of 4,500 shares in public offering, net of costs	3,000	93,668			96,668
Issuance of 1,485 shares for exercise of options, including tax benefit of \$2,969	990	22,087			23,077
Issuance of 126 shares for purchased company and strategic investment	84	2,576			2,660
Stock-based compensation		2,233			2,233
Cash dividends declared, \$0.213 per share			(20,968)		(20,968)
Balance at December 31, 2004	68,038	582,566	637,259	37,635	1,325,498
Net earnings			191,192		191,192
Other comprehensive loss				(18,561)	(18,561)
	4,688	145,276			149,964

Issuance of 4,688 shares in public offering, net of costs					
Issuance of 2,439 shares for exercise of options, including tax benefit of \$6,168	1,785	40,522			42,307
Issuance of 1,624 shares for purchased companies and convertible debt	1,227	26,226			27,453
Stock-based compensation		2,645			2,645
Three-for-two stock split	35,065	(35,065)			
Cash dividends declared, \$0.282 per share			(30,063)		(30,063)
Balance at December 31, 2005	\$ 110,803	\$ 762,170	\$ 798,388	\$ 19,074	\$ 1,690,435

See Notes to Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(in thousands)

	Years ended December 31,		
	2005	2004	2003
	(As	(As	(As
	restated)	restated)	restated)
Cash flows from operating activities:			
Net earnings	\$ 191,192	\$ 162,699	\$ 142,027
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Change in premium, claims and other receivables	(6,094)	70,411	(121,834)
Change in reinsurance recoverables	(250,829)	(198,536)	(103,580)
Change in ceded unearned premium	82,433	(17,422)	(127,367)
Change in loss and loss adjustment expense payable	705,688	548,349	366,398
Change in reinsurance balances payable	(49,772)	(72,009)	120,064
Change in unearned premium	38,809	122,317	261,261
Change in premium and claims payable, net of restricted cash	(3,851)	1,835	(24,743)
Gain on sale of subsidiaries	(8,717)	(6,317)	(52,681)
Change in trading portfolio	(66,809)	25,673	12,741
Depreciation and amortization expense	14,647	16,139	12,828
Stock-based compensation expense	2,645	2,233	2,979
Other, net	(25,352)	13,331	40,005
Cash provided by operating activities	623,990	668,703	528,098
Cash flows from investing activities:			
Sales of fixed income securities	237,480	253,398	167,357
Maturity or call of fixed income securities	186,075	154,357	142,652
Cost of securities acquired	(1,054,529)	(935,053)	(694,211)
Change in short-term investments	(72,703)	(160,229)	(202,904)
Payments for purchase of subsidiaries, net of cash received	(94,056)	(93,543)	(16,680)
Sale of subsidiaries and other operating investments	21,116		82,618
Other, net	3,637	268	(17,655)
Cash used by investing activities	(772,980)	(780,802)	(538,823)
Cash flows from financing activities:			
Issuance of notes payable, net of costs	46,528	29,000	174,845
Payments on notes payable	(48,181)	(40,176)	(108,813)
Sale of common stock, net of costs	186,103	116,776	20,279
Dividends paid and other, net	(31,458)	(19,984)	(19,476)

Cash provided by financing activities	152,992	85,616	66,835
Net increase (decrease) in cash	4,002	(26,483)	56,110
Cash at beginning of year	69,933	96,416	40,306
Cash at end of year	\$ 73,935	\$ 69,933	\$ 96,416

See Notes to Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(tables in thousands, except per share data)

(1) GENERAL INFORMATION AND SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

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

Our principal domestic insurance companies are Houston Casualty Company, U.S. Specialty Insurance Company, HCC Life Insurance Company, Avemco Insurance Company and American Contractors Indemnity Company. These companies operate throughout the United States with headquarters in Houston, Texas, Atlanta, Georgia and Los Angeles, California. All of our principal domestic insurance companies operate on an admitted basis, except Houston Casualty Company, which also insures international risks. Our foreign insurance companies are HCC International Insurance Company, HCC Europe, HCC Reinsurance Company and the London branch of Houston Casualty Company. These companies operate from the United Kingdom, Spain, Bermuda and Ireland.

Our underwriting agencies provide underwriting management and claims servicing for insurance and reinsurance companies, in specialized lines of business within the property and casualty and group life, accident and health insurance sectors. Our principal domestic agencies are Professional Indemnity Agency, Inc., HCC Specialty Underwriters, HCC Global Financial Products, Covenant Underwriters and HCC Indemnity Guaranty Agency. Our agencies operate throughout the United States. Our principal foreign agency is HCC Global Financial Products, with headquarters in Barcelona, Spain. In 2006, we intend to consolidate the operations of one of our foreign agencies, HCC Diversified Financial Products, into HCC International Insurance Company.

Our reinsurance and insurance brokers provide brokerage, consulting and other broker services to insurance and reinsurance companies, commercial customers and individuals in the same lines of business as the insurance companies and underwriting agencies operate. Our principal reinsurance brokers are Rattner Mackenzie and HCC Risk Management, operating principally in London, England, Hamilton, Bermuda and Houston, Texas. Our insurance broker is Continental Underwriters.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

Basis of Presentation

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Management must make estimates and assumptions that affect amounts reported in our financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. We have reclassified certain amounts in our 2004 and 2003 consolidated financial statements to conform to the 2005 presentation. The reclassifications included the elimination of certain intercompany premium receivable and premium payable balances in the consolidated balance sheet and reclassification of the corresponding lines in the consolidated statements of cash flows. None of our reclassifications had an effect on our consolidated net earnings, shareholders equity or cash flows.

Investments

All fixed income securities are classified as available for sale and reported at quoted market value, if readily marketable, or at management's estimated fair value, if not readily marketable. The change in unrealized gain or loss on these securities is recorded as a component of other comprehensive income, net of the related deferred income tax effect. We purchase fixed income securities with the intent to hold to maturity, but they may be available for sale if market conditions warrant or if our investment policies dictate in order to maximize our investment yield. For asset-backed and mortgage-backed securities in our fixed income portfolio, we recognize income using a constant effective yield based on anticipated prepayments and the estimated economic life of the securities. When actual prepayments differ significantly from anticipated prepayments, the estimated economic life is recalculated and the remaining unamortized premium or discount is amortized prospectively over the remaining economic life. Short-term investments and restricted cash investments are carried at cost, which approximates fair value. Other investments includes trading securities, which are carried at quoted market value. The change in unrealized gain or loss on trading securities, as well as realized gains or losses and dividend income thereon, are included in other operating income in the consolidated statements of earnings.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

Realized gains or losses are determined on an average cost basis and included in earnings on the trade date. When impairment of the value of an investment is considered other-than-temporary, the decrease in value is reported in earnings as a realized investment loss and a new cost basis is established. Declines in the market value of invested assets below cost are evaluated for other-than-temporary impairment losses on a quarterly basis. Impairment losses for declines in value of fixed income securities below cost attributable to issuer-specific events are based on all relevant facts and circumstances for each investment and are recognized when appropriate. For fixed income securities with unrealized losses due to market conditions or industry-related events where we have the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary.

Derivative Financial Instruments

We have reinsured interests in two long-term mortgage impairment insurance contracts. The exposure with respect to these two contracts is measured based on movement in a specified index. These insurance contracts qualify as derivative financial instruments, are unhedged and are reported in other assets at fair value, which was \$6.4 million and \$3.0 million at December 31, 2005 and 2004, respectively. We determine fair value based on our estimate of the present value of expected future cash flows, modified to reflect specific contract terms and validated based on current market quotes. Changes in fair value are recorded each period as a component of other operating income in the consolidated statements of earnings.

Net Earned Premium, Policy Acquisition Costs and Ceding Commissions

Substantially all of the property and casualty and accident and health policies written by our insurance companies qualify as short-duration contracts. We recognize in current earned income the portion of the premium that provides insurance coverage in the period. Written premium, net of reinsurance, is primarily recognized in earnings on a pro rata basis over the term of the related policies. However, for certain policies, written premium is recognized in earnings over the period of risk in proportion to the amount of insurance risk provided. Unearned premium represents the portion of premium written in relation to the unexpired term of coverage. Premium related to our group life policies is recognized when due. When coverage under a specific excess of loss reinsurance layer has been utilized, we effectively expense the remaining initial premium and defer and amortize the reinstatement premium over the period of risk.

We defer our direct costs to underwrite insurance policies, less amounts reimbursed by reinsurers, and charge or credit the costs to earnings proportionate with the premium earned. These policy acquisition costs include commissions, taxes, fees, and other direct underwriting costs. Historical and current loss adjustment expense experience and anticipated investment income are considered in determining premium deficiencies and the recoverability of deferred policy acquisition costs.

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Fee and Commission Income

Fee and commission income in our consolidated statements of earnings includes fee income from our underwriting agencies, commission income from our reinsurance brokers and proceeds from ceded reinsurance (ceding commissions in excess of acquisition costs). When there is no significant future servicing obligation, we recognize fee and commission income from third parties on the later of the effective date of the policy, the date when the premium can be reasonably established, or the date when substantially all services related to the insurance placement have been rendered to the client. We record revenue from profit commissions, which are based on the profitability of business written, at the end of each accounting period, calculated using the respective commission formula. Such amounts are adjusted should experience change. When additional services are required, the service revenue is deferred and recognized over the service period. We record an allowance for estimated return commissions that we may be required to pay on the early termination of policies. Proceeds from ceded reinsurance are earned pro rata over the term of the underlying policy.

When our underwriting agencies utilize one of our insurance company subsidiaries as the policy issuing company and the business is reinsured with a third-party reinsurer, we eliminate in consolidation the fee and commission income against the related insurance company's policy acquisition costs and defer the policy acquisition costs of the underwriting agencies.

Strategic Investments and Other Operating Income

Included in other assets are certain strategic investments in insurance-related companies. When we own a 20% to 50% equity interest in a strategic investment, the investment and income are recorded using the equity method of accounting. We carry the remaining investments that are marketable at fair value and the remaining investments that are not readily marketable at management's estimate of fair value. We record any interest, dividends and realized gains or losses in other operating income and unrealized gains or losses in other comprehensive income.

Premium, Claims and Other Receivables

We use the gross method for reporting receivables and payables on brokered transactions. We review the collectibility of our receivables on a current basis and provide an allowance for doubtful accounts if we deem that there are accounts that are doubtful of collection. The allowance was \$7.4 million and \$4.9 million at December 31, 2005 and 2004, respectively. Our estimate of the level of the allowance could change as conditions change in the future.

Loss and Loss Adjustment Expense Payable

Loss and loss adjustment expense payable by our insurance companies is based on estimates of payments to be made for reported losses, incurred but not reported losses, and anticipated receipts from salvage and subrogation. Reserves are recorded on an undiscounted basis, except for reserves of acquired companies. The discount on those reserves is not material. Estimates for reported losses are based on all available information, including reports received from ceding companies on assumed business. Estimates for incurred but not reported losses are based both on our experience and the industry's experience. While we believe that amounts included in our consolidated financial statements are adequate, such estimates may be more or less than the amounts ultimately paid when the claims are settled. We continually review the estimates with our actuaries and any changes are reflected in the period of the change.

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Reinsurance

We record all reinsurance recoverables and ceded unearned premium as assets, and deferred ceding commissions as liabilities. All such amounts are recorded in a manner consistent with the underlying reinsured contracts. We also record a reserve for uncollectible reinsurance. Our estimates utilized to calculate the reserve are subject to change, which could affect the level of the reserve required.

Goodwill and Intangible Assets

When we acquire a new subsidiary, goodwill is either allocated to that particular subsidiary or, if there are synergies with other subsidiaries, allocated to the different reporting units based on their respective share of the estimated future cash flows. In our agency segment, the reporting units are the individual subsidiaries. In our insurance company segment, the reporting units are either individual subsidiaries or groups of subsidiaries that share common licensing and other characteristics.

To determine the fair value of a reporting unit, we utilize the expected cash flow approach in Statement of Financial Accounting Concepts CON 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. This approach utilizes a risk-free rate of interest, estimates of future cash flows, and probabilities as to the occurrence of the future cash flows. We utilize our budgets and projection of future operations based on historical and expected industry trends to estimate our future cash flows and their probability of occurring as projected.

We assess the impairment of goodwill annually, or sooner if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Based on our latest impairment test, the fair value of each of our reporting units exceeded its carrying amount. Intangible assets not subject to amortization are tested for impairment annually, or sooner if an event occurs or circumstances change that indicate that an intangible asset might be impaired. Other intangible assets are amortized over their respective useful lives.

Cash and Short-term Investments

Cash consists of cash in banks, generally in operating accounts. We classify certificates of deposit and money market funds as short-term investments. Short-term investments are classified as investments in our consolidated balance sheets as they relate principally to our investment activities.

We generally maintain our cash deposits in major banks and invest our short-term investments in institutional money-market funds and in investment grade commercial paper and repurchase agreements. These securities typically mature within ninety days and, therefore, bear minimal risk. We have not experienced any losses on our cash deposits or our short-term investments.

Certain fiduciary funds totaling \$286.1 million and \$295.2 million were included in cash, short-term investments and fixed income securities at December 31, 2005 and 2004, respectively. These funds are held by underwriting agencies, reinsurance brokers, or surety companies for the benefit of insurance or reinsurance clients. We earn the interest on these funds net of expenses.

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Restricted Cash and Cash Investments

Our agencies withhold premium funds for the payment of claims. These funds are shown as restricted cash and cash investments in our consolidated balance sheets. The corresponding liability is included within premium and claims payable in our consolidated balance sheets. These amounts are considered fiduciary funds, and interest earned on these funds accrues to the benefit of the insurance companies for whom the agencies write business. Therefore, we do not include these amounts as cash in our consolidated statements of cash flows.

Foreign Currency

The functional currency of some of our foreign subsidiaries and branches is the U.S. dollar. Assets and liabilities recorded in foreign currencies are translated into U.S. dollars at exchange rates in effect at the balance sheet date. Transactions in foreign currencies are translated at the rates of exchange in effect on the date the transaction occurs. Transaction gains and losses are recorded in earnings and included in other operating expenses. Our foreign currency transactions are principally denominated in British pound sterling and the Euro. The gain (loss) from currency conversion was \$(1.0) million, \$1.2 million and \$3.7 million in 2005, 2004 and 2003, respectively. The 2003 amount included a one-time gain of \$1.3 million from settlement of an advance of funds to an unaffiliated entity. We utilize the Euro, the British pound sterling and the Canadian dollar as the functional currency in our other foreign operations. The cumulative translation adjustment, representing the effect of translating these subsidiaries' assets and liabilities into U.S. dollars, is included in the foreign currency translation adjustment within accumulated other comprehensive income. The effect of exchange rate changes on cash balances held in foreign currencies was immaterial for all periods presented and is not shown separately in the consolidated statements of cash flows.

Income Taxes

We file a consolidated Federal income tax return and include the foreign subsidiaries' income to the extent required by law. Deferred income tax is accounted for using the liability method, which reflects the tax impact of temporary differences between the bases of assets and liabilities for financial reporting purposes and such bases as measured by tax laws and regulations. We provide a deferred tax liability for un-repatriated earnings of our foreign subsidiaries at prevailing statutory rates when required. Due to our history of earnings, expectations for future earnings, and taxable income in carryback years, we expect to be able to fully realize the benefit of any net deferred tax asset.

Earnings Per Share

Basic earnings per share is computed by dividing net earnings by the weighted average number of common shares outstanding during the year. Diluted earnings per share is computed by dividing net earnings by the weighted average number of common shares outstanding plus potential common shares outstanding during the year. Outstanding common stock options, when dilutive, are considered to be potential common shares in the diluted calculation. Also included are common shares that would be issued for any premium in excess of the principal amount of our convertible debt. We use the treasury stock method to calculate potential common shares outstanding due to options and our convertible debt.

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Stock-Based Compensation

As allowed under SFAS No. 123, *Accounting for Stock-Based Compensation*, we account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* and its related interpretations. Under APB No. 25, compensation cost is measured as of the date the number of shares and exercise price become fixed. The terms of an award are generally fixed on the date of grant, requiring the stock option to be accounted for as a fixed award. For fixed awards, compensation expense is measured as the excess, if any, of the quoted market price of our stock at the date of grant over the exercise price of the option granted. Compensation expense for fixed awards is recognized ratably over the vesting period using the straight-line single option method.

If the number of shares or exercise price is not fixed upon the date of grant, the award is accounted for as a variable award until the number of shares or the exercise price become fixed, or until the award is exercised, canceled, or expires unexercised. For variable awards, intrinsic value is remeasured each period and is equal to the fair market value of our stock as of the end of the reporting period less the grant exercise price. As a result, the amount of compensation expense or benefit to be recognized each period fluctuates based on change in our closing price from the end of the previous reporting period to the end of the current reporting period. In cases when our closing stock price does not exceed the recipient's exercise price, no compensation expense results. Compensation expense for variable awards, if any, is recognized in accordance with FIN No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plan, An Interpretation of APB Opinions No. 15 and 25*.

We account for modifications to stock options under APB No. 25, as subsequently interpreted by FIN No. 44 *Accounting for Certain Transactions Involving Stock Compensation – an interpretation of APB Opinion No. 25*. Modifications include, but are not limited to, acceleration of vesting, extension of the exercise period following termination of employment and/or continued vesting while not providing substantive services. Compensation expense for modified awards is recorded in the period of modification for the intrinsic value of the vested portion of the award, including vesting that occurs while not providing substantive services, after the date of modification. The intrinsic value of the award is the difference between the fair market value of our common stock on the date of modification and the recipient's exercise price.

Stock options issued to non-employees are accounted for in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. Compensation expense for stock options issued to non-employees is valued using the Black-Scholes model and is amortized over the vesting period in accordance with FIN No. 28.

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The following table illustrates what the effect on net earnings and earnings per share would be if we had used the fair value method of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, to value stock options.

	2005 (As restated)	2004 (As restated)	2003 (As restated)
Reported net earnings	\$ 191,192	\$ 162,699	\$ 142,027
Stock-based compensation included in reported net earnings, net of income taxes	2,114	1,920	2,359
Stock-based compensation using fair value method, net of income taxes	(8,258)	(6,140)	(9,031)
Pro forma net earnings	\$ 185,048	\$ 158,479	\$ 135,355
Reported basic earnings per share	\$ 1.81	\$ 1.67	\$ 1.50
Fair value stock-based compensation	(0.06)	(0.04)	(0.07)
Pro forma basic earnings per share	\$ 1.75	\$ 1.63	\$ 1.43
Reported diluted earnings per share	\$ 1.75	\$ 1.65	\$ 1.47
Fair value stock-based compensation	(0.06)	(0.05)	(0.07)
Pro forma diluted earnings per share	\$ 1.69	\$ 1.60	\$ 1.40

For purposes of the above presentation, we estimate the fair value of each option grant on the grant date using the Black-Scholes single option pricing model. The table below shows the average fair value of options granted and the related assumptions used in the model.

	2005	2004	2003
Average fair value of options (As restated):			
Granted at market value	\$ 7.17	\$ 6.34	\$ 4.38
Granted below market value	8.96	6.11	4.90
Risk free interest rate	4.0%	3.4%	2.8%
Expected volatility factor	32%	32%	32%
Dividend yield	1.11%	1.02%	1.07%
Expected option life	4.8 years	4.5 years	4.4 years

The Financial Accounting Standards Board (FASB) has issued SFAS No. 123(R), *Share-Based Payment*, which requires companies to recognize the fair value of stock-based compensation cost, with adoption required as of January 1, 2006. SFAS 123(R) allows either a prospective or retrospective adoption method. We will adopt SFAS 123(R) in 2006 using the modified prospective method, whereby results for prior periods will not be restated. Compensation expense recognized going forward will be based on our unvested stock options granted before January 1, 2006 and all options granted after that date. We will use the Black-Scholes option pricing model to determine the fair value of an option on its grant date and will expense that value over the option's vesting period. At December 31, 2005, there was approximately \$43.7 million of total unrecognized compensation expense related to unvested options that is expected to be recognized through 2010, of which we expect to recognize approximately

\$13.6 million in 2006.

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Had we adopted SFAS 123(R) in prior periods, the impact would have approximated the pro forma net income and earnings per share amounts calculated under SFAS 123, as disclosed above. The ultimate impact of adoption of SFAS 123(R) in future periods will depend on the following: 1) the amount and timing of options granted, exercised and forfeited, 2) the assumptions used to model fair value and 3) certain tax reporting requirements. We generally recognize a tax benefit when our employees exercise options. SFAS 123(R) requires that, in future periods, we report the benefit of tax deductions in excess of recognized compensation expense as a financing cash flow, rather than as an operating cash flow. We cannot estimate what the tax benefits or cash flow amounts will be in the future because they depend on a variety of factors, including when employees exercise stock options. However, we recognized operating cash flows of \$6.2 million, \$3.0 million and \$1.8 million in 2005, 2004 and 2003, respectively, for tax deductions associated with options exercised.

Stock Split

In May 2005, the Board of Directors declared a three-for-two stock split in the form of a 50% stock dividend on our shares of \$1.00 par value common stock, payable to shareholders of record on July 1, 2005. The distribution, consisting of 35.1 million newly issued shares, was reflected as of June 30, 2005 in our consolidated financial statements. The distribution had no impact on consolidated shareholders' equity, results of operations or cash flows. All references in the Consolidated Financial Statements and Notes to the number of shares outstanding, per share amounts, and stock option and convertible debt data have been restated to reflect the effect of the stock split for all periods presented.

Large Loss Events

During 2005 and 2004, catastrophic events occurred related to three major hurricanes, Katrina, Rita and Wilma, and two minor ones (collectively, the 2005 hurricanes) and four major hurricanes, Charley, Frances, Ivan and Jeanne (collectively, the 2004 hurricanes). As a result of these events, we recognized a pre-tax loss, after reinsurance, of \$89.7 million in 2005 and \$33.1 million in 2004 in our insurance company segment. The 2005 loss included \$73.2 million recorded in loss and loss adjustment expense and \$16.5 million for premiums to reinstate our excess of loss reinsurance protection, which reduced net earned premium. The 2004 loss included \$23.3 million of loss and loss adjustment expense and \$9.8 million of reinstatement premium. Net earnings were reduced \$58.2 million in 2005 and \$21.5 million in 2004.

During the past three years, we reached agreements with various reinsurers to commute certain reinsurance recoverables, some of which related to our discontinued accident and health line of business. In 2005 and 2003, we received cash payments that were less than the related recoverables, from certain reinsurers, in consideration for discounting the recoverables and reassuming the associated loss reserves. We recorded a pre-tax loss of \$26.0 million in 2005 and \$28.8 million in 2003 related to these commutations, which were included in loss and loss adjustment expense in our insurance company segment. Net earnings were reduced \$16.9 million in 2005 and \$18.7 million in 2003.

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The following table shows the reported amounts, as well as the effect of the hurricanes and commutations on those amounts.

				Effect of hurricanes and commutations		
	2005	2004	2003	2005	2004	2003
	(As restated)	(As restated)	(As restated)			
Gross incurred loss and loss adjustment expense	\$ 1,596,773	\$ 1,289,155	\$ 1,045,339	\$ 394,625	\$ 89,795	\$
Net incurred loss and loss adjustment expense	919,697	645,230	488,000	99,226	23,335	28,751
Ceded earned premium	617,402	849,610	748,799	16,533	9,806	
Net earnings (loss)	191,192	162,699	142,027	(75,171)	(21,464)	(18,688)

Recent Accounting Pronouncements

The FASB has issued FASB Staff Position (FSP) No. 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The FSP requires recognition of an impairment loss on a debt security no later than when the investor deems the impairment is other-than-temporary, even if the investor has not decided to sell the security. This standard replaces current guidance in Emerging Issues Task Force Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The new standard is effective January 1, 2006. We expect that adoption of this FSP will have an immaterial impact on our consolidated financial position and results of operations.

The FASB has issued SFAS No. 154, *Accounting Changes and Error Corrections*, as a replacement of APB No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 requires restatement of all prior period financial statements if a company makes an accounting change or corrects an error. The standard is effective January 1, 2006. We will apply the standard, if applicable, in the future.

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(2) RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS, SPECIAL COMMITTEE AND COMPANY FINDINGS

In light of published reports concerning the pricing of stock options and the timing of stock option grants at numerous other companies, in the second quarter of 2006 we undertook a voluntary internal review of our past practices related to grants of stock options. The voluntary review by our management concluded that the actual accounting measurement dates for certain past stock option grants differed from the originally stated grant dates, which were also utilized as the measurement dates for such awards. In August 2006, our Board of Directors formed a Special Committee of independent directors to commence an investigation of our past stock option granting practices for the period 1995 through 2005. The Special Committee was composed of the members of the Audit Committee of the Board of Directors. The Special Committee retained the law firm of Skadden, Arps, Slate, Meagher & Flom, LLP as its independent legal counsel and LECG as forensic accountants to aid in the investigation.

On November 17, 2006, we announced that the Special Committee had made certain determinations as a result of its review of our past stock option granting practices. The Special Committee found that we had used incorrect accounting measurement dates for stock option grants covering a significant number of employees and members of our Board of Directors during the period 1997 through 2005 and that certain option grants were retroactively priced. Additionally, at the direction of the Special Committee, we reviewed our stock option granting practices from 1992, the year of our initial public stock offering, through 1994 and in 2006 and found incorrect measurement dates due to retroactive pricing were used in 2006. In substantially all of these instances, the price on the actual measurement date was higher than the price on the stated grant date; thus recipients of the options could exercise at a strike price lower than the actual measurement date price. To determine the actual measurement dates, the Special Committee utilized the following sources of information:

The dates on documentation such as e-mails, regulatory form filings, acquisition agreements and other correspondence;

The date that the relevant stock option grant was entered into Equity Edge, our stock option tracking and accounting system;

Requirements of Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations; and

Guidance from the Office of Chief Accountant of the Securities and Exchange Commission (SEC) contained in a letter dated September 19, 2006.

The Special Committee concluded that mis-priced option grants, the effect of which, together with certain other adjustments, resulted in a cumulative net decrease in shareholders' equity at December 31, 2005 of \$3.3 million, affected all levels of employees. The Special Committee found that Stephen L. Way, Chief Executive Officer, retroactively priced options, that he should have known he was granting options in a manner that conflicted with our stock option plans and public statements, and that this constituted a failure to align the stock option granting process with our stock option plans and public statements. Although finding his actions were inconsistent with the duties and obligations of a chief executive officer of a publicly-traded company, the Special Committee also found that Mr. Way's motivation appeared to be the attraction and retention of talent and to provide employees with the best

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option price. The Special Committee also concluded that Christopher L. Martin, Executive Vice President and General Counsel, was aware that options were being retroactively priced in a manner inconsistent with applicable plan terms and the procedures memoranda that he had prepared, that granting in-the-money options had accounting implications, and that he did not properly document our Compensation Committee's informal delegation of authority to Mr. Way. The Special Committee also found that there was no evidence that Mr. Way or Mr. Martin intended to falsify the consolidated financial statements.

Before the Board of Directors reviewed the results of the investigation, the Chairman of our Compensation Committee tendered his resignation from the Board of Directors on November 8, 2006. After reviewing the results of the investigation, the Board of Directors determined that it would be appropriate to accept the resignations of Mr. Way and Mr. Martin, which both tendered on November 17, 2006. Mr. Way will remain a director of HCC and serve as the non-executive Chairman of the Board of Directors and has entered into a consulting agreement with us to assist in the transition of leadership and to provide strategic guidance. We have entered into agreements with Mr. Way and Mr. Martin which, among other things, require them to disgorge an amount equal to the difference between the actual measurement date prices determined by HCC and the prices at which these individuals exercised mis-priced options since 1997.

As a result of the determinations of the Special Committee and because the resulting cumulative charge would be material to the second quarter and full year 2006 consolidated net earnings, we concluded that we needed to amend this Annual Report on Form 10-K for the year ended December 31, 2005 as filed on March 16, 2006 (the Original Filing), to restate our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 and the related disclosures. However, the impact of the restatement in any of the periods is not material. We are making the restatement in accordance with generally accepted accounting principles to record the following:

Non-cash compensation expense for the difference between the stock price on the stated grant date and the actual measurement date and for the fluctuations in stock price in certain instances where variable accounting should have been applied.

Other adjustments that were not recorded in the originally filed financial statements due to their immateriality. These minor adjustments primarily relate to fee and commission income, loss and loss adjustment expense, policy acquisition costs and other operating expense. In addition, balance sheet reclassifications have been recorded to appropriately present certain reinsurance recoverables and payables.

Related tax benefits associated with the recognition of non-cash compensation expense and other adjustments as well as additional taxes that may be due and payable.

Based on the determinations of the Special Committee and our voluntary internal review, we identified a number of occasions during the period 1997 through 2005 and into 2006 on which we used an incorrect measurement date for financial accounting and reporting purposes for options granted. In accordance with Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*, and its related interpretations, we should have recorded compensation expense related to these options for the excess of the market price of our stock on the actual measurement date over the exercise price of the option. For periods commencing January 1, 2006, compensation expense is being recognized in accordance with Statement of Financial Accounting Standards (SFAS) No. 123(R) (revised), *Share-Based Payment*. However, we determined an incremental amount related to the mis-priced options must be recorded.

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The types of errors identified were as follows:

We determined that many block grants to employees during the period 1997 through 2005 were subject to a retroactive look-back period. In all such cases, the price of our stock at the end of the look-back period, which was generally 30 days or less, was higher than the price of our stock on the stated grant date.

In addition to being subject to the retroactive pricing discussed above, we determined that the strike price of block grants in 1999, 2002 and 2005 was determined prior to the final determination of the identity of the employee and/or the number of options to be granted. Further, proper approval, in most cases, had not been given until after the grant date. In all such cases, the price of our stock at the time when all required determinations were final and proper approval had been obtained was higher than the price of our stock on the stated grant date. The time lag between the stated grant date and the finalization of the awards was typically 30-45 days, except in the case of the 2002 grant which was finalized several months subsequent to the stated grant date.

For the period from 1997 to 2005 and into 2006, we determined that there was a regular practice of granting options to newly hired employees and existing employees being promoted after the end of a 30-45 day period following the hire or promotion date. This practice included the use of the 30-45 day period as a look-back period during which the date with the lowest price during that period was selected as the stated grant date.

In several instances, grants to senior executives were determined at a date subsequent to the stated grant date. In most cases, this resulted from extended negotiations of employment agreements and, in some cases, administrative delays. In virtually all cases, the price of our stock at the time the grants were made and properly approved was higher than the price of our stock on the stated grant date.

In a few cases, options were granted and then repriced downward. As a result, variable accounting should have been applied to these options.

We lacked timely or adequate documentation to support the stated grant date in the case of certain of the above errors.

The gross compensation expense recorded to correct the above errors was a non-cash charge and had no impact on our reported net revenue, cash, cash flow or shareholders' equity.

In connection with the investigation, we determined that a number of executive officers received in-the-money options. If such options are ultimately determined to be in-the-money grants for tax purposes, pursuant to Section 162(m) of the Internal Revenue Code and, if in the year of exercise the officers' compensation, including proceeds from options exercised, exceeded \$1.0 million, we would not be entitled to a tax deduction for any amount in excess of such \$1.0 million for officers covered by Section 162(m). We estimate the tax effect of the deduction was \$4.6 million, substantially all of which was recorded as a reduction to shareholders' equity.

There were immaterial adjustments that were not made in the originally filed consolidated financial statements. We have taken the opportunity presented by this restatement to record these adjustments, which amounted to a net \$2.4 million increase in earnings from continuing operations before income tax expense, for the years 2001 through 2005.

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The cumulative effect of the restatement for the period 1997 through 2005 was as follows (in thousands):

Increase (decrease) in net earnings and retained earnings:		
Non-cash compensation expense related to stock option grants (including \$994 recorded as accrued expenses)	\$ (26,608)	
Net adjustments for immaterial items previously unrecorded	1,316	
Reduction in earnings from continuing operations before income tax expense	(25,292)	
Related income tax benefit	6,667	
Reduction in net earnings from continuing operations and net earnings		\$ (18,625)
Increase (decrease) to additional paid-in capital:		
Increase related to non-cash compensation expense	\$ 25,614	
Reduction related to tax effects previously credited to additional paid-in capital	(11,012)	
Net increase in additional paid-in capital		14,602
Increase in other comprehensive income for immaterial items previously unrecorded		762
Net decrease in shareholders' equity at December 31, 2005		\$ (3,261)

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In order to further enhance investor understanding of the effects of the matters described above and to provide context for the composition of the cumulative adjustment to shareholders' equity at December 31, 2002, we have provided the information below which shows the years to which the stock option compensation adjustments relate. Our consolidated financial statements and the related SEC reports for such periods have not been amended, except for the consolidated financial statements included in this Form 10-K/A. In addition to the stock option compensation adjustments, we also included the effect of other immaterial adjustments which were previously unrecorded and the related tax effects of all adjustments. The increase (decrease) in net earnings for each type of adjustment was as follows (in thousands):

Years ended	Net earnings as previously reported	Non-cash stock option compensation		Tax effect	Total adjustments	Net earnings as restated
		expense	Other			
December 31, 1997		\$ (3,789)	\$	\$ 1,326	\$ (2,463)	
1998		(3,664)		1,273	(2,391)	
1999		(1,474)		(148)	(1,622)	
2000		(4,586)	(1,124)	1,830	(3,880)	
2001		(2,201)	1,881	88	(232)	
2002		(2,043)	(27)	561	(1,509)	
Cumulative effect at						
December 31, 2002		(17,757)	730	4,930	(12,097)	
2003	143,561	(3,279)	1,270	475	(1,534)	142,027
2004	163,025	(2,571)	2,453	(208)	(326)	162,699
2005	195,860	(3,001)	(3,137)	1,470	(4,668)	191,192
Cumulative effect at						
December 31, 2005		\$ (26,608)	\$ 1,316	\$ 6,667	\$ (18,625)	

The restatement adjustments reduced previously reported diluted net earnings per share by \$0.04, \$0.00, \$0.02, \$0.01 and \$0.00 for 2005, 2004, 2003, 2002 and 2001, respectively.

We are also amending certain other stock option disclosures in the accompanying notes to the consolidated financial statements.

Enacted October 22, 2004, Section 409A of the Internal Revenue Code significantly changed the rules for nonqualified deferred compensation plans. Section 409A imposes certain restrictions and taxes on stock awards that constitute deferred compensation. Section 409A relates specifically to the personal tax liabilities of our employees that have received discounted options. We are currently reviewing the implications of Section 409A on grants awarded with intrinsic value that vested after December 31, 2004 and modifications made to existing grants after October 3, 2004 along with potential remedial actions.

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For explanatory purposes and to assist in analysis of our consolidated financial statements, we have summarized the effect of each type of adjustment by period as follows (in thousands).

	Years Ended December 31,			1997 through 2002	Cumulative January 1, 1997 through December 31, 2005
	2005	2004	2003		
Non-cash compensation expense, related to stock option grants (including \$994 recorded as accrued expenses)	\$ (3,001)	\$ (2,571)	\$ (3,279)	\$ (17,757)	\$ (26,608)
Net adjustments for immaterial items previously unrecorded	(3,137)	2,453	1,270	730	1,316
Reduction in earnings from continuing operations before income tax expense	(6,138)	(118)	(2,009)	(17,027)	(25,292)
Related income tax (expense) benefit	1,470	(208)	475	4,930	6,667
Reduction in net earnings from continuing operations	\$ (4,668)	\$ (326)	\$ (1,534)	\$ (12,097)	\$ (18,625)

The effect of these pre-tax adjustments on our previously reported consolidated statements of earnings was as follows:

	Years Ended December 31,			1997 through 2002	Cumulative January 1, 1997 through December 31, 2005
	2005	2004	2003		
Revenue	\$ (1,654)	\$ 1,453	\$	\$	\$ (201)
Loss and loss adjustment expense, net	1,500		652	(652)	1,500
Policy acquisition costs, net	(3,983)	2,000	1,000	1,000	17
Other operating expense	(2,001)	(3,571)	(3,661)	(17,375)	(26,608)
Total reductions in earnings from continuing operations before income tax	\$ (6,138)	\$ (118)	\$ (2,009)	\$ (17,027)	\$ (25,292)

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The following table sets forth the impact of the above adjustments and the related tax effects on our historical statements of earnings for each of the three years ended December 31, 2005.

	Year ended December 31, 2005			Year ended December 31, 2004			Year ended December 31, 2003		
	As previously reported			As previously reported			As previously reported		
	reported	Adjustments	As restated	reported	Adjustments	As restated	reported	Adjustments	As restated
REVENUE									
Net earned premium	\$ 1,369,988	\$	\$ 1,369,988	\$ 1,010,692	\$	\$ 1,010,692	\$ 738,272	\$	\$ 738,272
Fee and commission income	134,282	(1,654)	132,628	182,349	1,453	183,802	142,615		142,615
Net investment income	98,851		98,851	64,885		64,885	47,335		47,335
Net realized investment gain	1,448		1,448	5,822		5,822	527		527
Other operating income	39,773		39,773	19,406		19,406	13,215		13,215
Total revenue	1,644,342	(1,654)	1,642,688	1,283,154	1,453	1,284,607	941,964		941,964
EXPENSE									
Loss and loss adjustment expense, net	921,197	(1,500)	919,697	645,230		645,230	488,652	(652)	488,000
Policy acquisition costs, net	257,725	3,983	261,708	224,323	(2,000)	222,323	138,212	(1,000)	137,212
Other operating expense	178,989	2,001	180,990	164,474	3,571	168,045	140,913	3,661	144,574
Interest expense	7,684		7,684	8,374		8,374	7,453		7,453
Total expense	1,365,595	4,484	1,370,079	1,042,401	1,571	1,043,972	775,230	2,009	777,239
Earnings from	278,747	(6,138)	272,609	240,753	(118)	240,635	166,734	(2,009)	164,725

continuing operations before income tax expense									
Income tax expense on continuing operations	85,647	(1,470)	84,177	81,732	208	81,940	59,857	(475)	59,382
Earnings from continuing operations	193,100	(4,668)	188,432	159,021	(326)	158,695	106,877	(1,534)	105,343
Earnings from discontinued operations, net of income taxes	2,760		2,760	4,004		4,004	36,684		36,684
Net earnings	\$ 195,860	\$ (4,668)	\$ 191,192	\$ 163,025	\$ (326)	\$ 162,699	\$ 143,561	\$ (1,534)	\$ 142,027
Basic earnings per share data:									
Earnings from continuing operations	\$ 1.83	\$ (0.05)	\$ 1.78	\$ 1.64	\$ (0.01)	\$ 1.63	\$ 1.12	\$ (0.01)	\$ 1.11
Earnings from discontinued operations	0.03		0.03	0.04		0.04	0.39		0.39
Net earnings	\$ 1.86	\$ (0.05)	\$ 1.81	\$ 1.68	\$ (0.01)	\$ 1.67	\$ 1.51	\$ (0.01)	\$ 1.50
Weighted average shares outstanding	105,463		105,463	97,257		97,257	94,919		94,919
Diluted earnings per share data:									
Earnings from continuing operations	\$ 1.76	\$ (0.04)	\$ 1.72	\$ 1.61	\$	\$ 1.61	\$ 1.11	\$ (0.02)	\$ 1.09
Earnings from	0.03		0.03	0.04		0.04	0.38		0.38

discontinued
operations

Net earnings	\$	1.79	\$	(0.04)	\$	1.75	\$	1.65	\$		\$	1.65	\$	1.49	\$	(0.02)	\$	1.47
Weighted average shares outstanding		109,437				109,437		98,826				98,826		96,576				96,576

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HCC Insurance Holdings, Inc. and Subsidiaries
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The following table sets forth the impact of the above adjustments and the related tax effects on our historical consolidated balance sheets as of December 31, 2005 and 2004.

	December 31, 2005			December 31, 2004		
	As previously reported	Adjustments	As restated	As previously reported	Adjustments	As restated
ASSETS						
Investments:						
Fixed income securities	\$ 2,268,624	\$	\$ 2,268,624	\$ 1,703,171	\$	\$ 1,703,171
Short-term investments	839,581		839,581	729,985		729,985
Other investments	149,223		149,223	35,335		35,335
Total investments	3,257,428		3,257,428	2,468,491		2,468,491
Cash	73,935		73,935	69,933		69,933
Restricted cash and cash investments	170,978		170,978	188,510		188,510
Premium, claims and other receivables	884,654		884,654	889,800	1,560	891,360
Reinsurance recoverables	1,360,483	1,500	1,361,983	1,104,026		1,104,026
Ceded unearned premium	239,416		239,416	317,055	(5,082)	311,973
Ceded life and annuity benefits	73,415		73,415	74,627		74,627
Deferred policy acquisition costs	156,253		156,253	139,199		139,199
Goodwill	532,947		532,947	444,031		444,031
Other assets	276,557	1,234	277,791	208,954	(536)	208,418
Total assets	\$ 7,026,066	\$ 2,734	\$ 7,028,800	\$ 5,904,626	\$ (4,058)	\$ 5,900,568
LIABILITIES						
Loss and loss adjustment expense payable	\$ 2,813,720	\$	\$ 2,813,720	\$ 2,089,199	\$	\$ 2,089,199
Life and annuity policy benefits	73,415		73,415	74,627		74,627
Reinsurance balances payable	176,954		176,954	228,998	(11,060)	217,938
Unearned premium	807,109		807,109	741,706		741,706
Deferred ceding commissions	65,702	2,184	67,886	94,896	(1,416)	93,480
Premium and claims payable	753,859		753,859	766,765		766,765
Notes payable	309,543		309,543	311,277		311,277
Accounts payable and accrued liabilities	332,068	3,811	335,879	273,493	6,585	280,078

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Total liabilities	5,332,370	5,995	5,338,365	4,580,961	(5,891)	4,575,070
SHAREHOLDERS						
EQUITY						
Common stock	110,803		110,803	68,038		68,038
Additional paid-in capital	747,568	14,602	762,170	566,776	15,790	582,566
Retained earnings	817,013	(18,625)	798,388	651,216	(13,957)	637,259
Accumulated other comprehensive income	18,312	762	19,074	37,635		37,635
Total shareholders equity	1,693,696	(3,261)	1,690,435	1,323,665	1,833	1,325,498
Total liabilities and shareholders equity	\$ 7,026,066	\$ 2,734	\$ 7,028,800	\$ 5,904,626	\$ (4,058)	\$ 5,900,568

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HCC Insurance Holdings, Inc. and Subsidiaries
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(continued, tables in thousands, except per share data)

Our restated consolidated balance sheets for 2005 and 2004 reflect a \$18.6 million and \$14.0 million, respectively, decrease to retained earnings and a \$14.6 million and \$15.8 million, respectively, increase to additional paid-in capital primarily due to additional non-cash stock-based compensation recorded in connection with this restatement to correct prior year stock option-related accounting errors as described above. In 2005 and 2004, the \$1.2 million and \$(0.5) million, respectively, increase (decrease) to deferred tax assets (included in other assets) and \$5.8 million and \$2.1 million, respectively, increase to income taxes payable (included in accounts payable and accrued liabilities) resulted primarily due to the non-deductibility of certain stock-based compensation costs recorded in connection with the restatement.

The restatement did not impact our net cash flows from operating, investing, or financing activities. However, certain items within net cash provided by operating activities were affected by the restatement adjustments. The following table shows the effect of the restatement on our previously reported cash flows:

	2005		Years Ended December 31, 2004		2003	
	As previously reported	As restated	As previously reported	As restated	As previously reported	As restated
Net earnings	\$ 195,860	\$ 191,192	\$ 163,025	\$ 162,699	\$ 143,561	\$ 142,027
Adjustments to reconcile net earnings to net cash provided by operating activities:						
Change in premium, claims and other receivables	(7,654)	(6,094)	70,136	70,411	(134,112)	(121,834)
Change in reinsurance recoverables	(249,329)	(250,829)	(183,121)	(198,536)	(117,256)	(103,580)
Change in ceded unearned premium	87,515	82,433	(22,504)	(17,422)	(127,367)	(127,367)
Change in loss and loss adjustment expense payable	705,688	705,688	538,374	548,349	379,998	366,398
Change in reinsurance balances payable	(60,832)	(49,772)	(69,647)	(72,009)	130,257	120,064
Change in premium and claims payable, net of restricted cash	(3,851)	(3,851)	6,928	1,835	(22,263)	(24,743)
Stock-based compensation expense		2,645		2,233		2,979
Other, net	(21,337)	(25,352)	7,700	13,331	41,131	40,005

In connection with the preparation of our restated financial statements, we also determined that the pro forma disclosures for stock-based compensation expense required under Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* included in Note 1 of the Notes to Consolidated Financial Statements, were incorrect. Specifically, the errors related to the effect on the consolidated financial statements resulting from the improper application of APB No. 25 to certain stock option transactions and the use of assumptions for determining the fair value of our stock options on the date of grant. We have corrected these errors in

Note 1 to the consolidated financial statements. These corrections do not affect our consolidated balance sheets, consolidated statements of earnings or consolidated statements of cash flows for any period.

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The following table presents the effect of these corrections on our pro forma calculation of our net income and earnings per share for the years ended December 31, 2005, 2004, and 2003.

	2005		2004		2003	
	As previously reported	As restated	As previously reported	As restated	As previously reported	As restated
Reported net earnings	\$ 195,860	\$ 191,192	\$ 163,025	\$ 162,699	\$ 143,561	\$ 142,027
Stock-based compensation included in reported net earnings, net of income taxes		2,114		1,920		2,359
Stock-based compensation using fair value method, net of income taxes	(6,916)	(8,258)	(4,883)	(6,140)	(7,705)	(9,031)
Pro forma net earnings	\$ 188,944	\$ 185,048	\$ 158,142	\$ 158,479	\$ 135,856	\$ 135,355
Reported basic earnings per share	\$ 1.86	\$ 1.81	\$ 1.68	\$ 1.67	\$ 1.51	\$ 1.50
Fair value stock-based compensation	(0.07)	(0.06)	(0.05)	(0.04)	(0.08)	(0.07)
Pro forma basic earnings per share	\$ 1.79	\$ 1.75	\$ 1.63	\$ 1.63	\$ 1.43	\$ 1.43
Reported diluted earnings per share	\$ 1.79	\$ 1.75	\$ 1.65	\$ 1.65	\$ 1.49	\$ 1.47
Fair value stock-based compensation	(0.06)	(0.06)	(0.05)	(0.05)	(0.08)	(0.07)
Pro forma diluted earnings per share	\$ 1.73	\$ 1.69	\$ 1.60	\$ 1.60	\$ 1.41	\$ 1.40

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HCC Insurance Holdings, Inc. and Subsidiaries
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(continued, tables in thousands, except per share data)

(3) ACQUISITIONS, GOODWILL AND DISPOSITION**Acquisitions**

During the past three years, we have completed numerous acquisitions. We acquired these companies to diversify into new specialty lines of business or to grow existing lines of business. The business combinations were recorded using the purchase method of accounting, and the results of operations of the acquired businesses were included in our consolidated financial statements beginning on the effective date of each transaction. The following table provides additional information on these acquisitions (in millions):

	Effective date	Initial consideration	Goodwill recognized	Deductible goodwill
Covenant Underwriters and Continental Underwriters	July 1, 2003	\$ 19.9	\$ 19.1	Yes
American Contractors Indemnity Company	January 31, 2004	46.8	10.5	No
RA&MCO Insurance Services	October 1, 2004	8.5	7.7	No
United States Surety Company	March 1, 2005	19.4	12.6	No
HCC International Insurance Company (formerly De Montfort Insurance Company)	July 1, 2005	24.6	15.8	No
Perico Life Insurance Company (formerly MIC Life Insurance Corporation)	November 30, 2005	20.0		Yes
Perico Ltd.	December 1, 2005	33.4	31.8	Yes
Illium Insurance Group	December 31, 2005	3.0	1.5	No

In the above table, the initial consideration column represents cash and the value of our common stock paid for the acquisition. The goodwill recognized column represents goodwill recorded through December 31, 2005, including earnout amounts based on earnings of the acquired company subsequent to its acquisition. The deductible goodwill column indicates if the goodwill is deductible for income tax purposes.

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HCC Insurance Holdings, Inc. and Subsidiaries
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We accrue earnout amounts when the conditions for their accrual have been satisfied under the applicable agreement. At December 31, 2005, accrued earnouts totaled \$32.3 million. In addition, we will pay up to a maximum of \$9.2 million with respect to two of the acquisitions if certain earnings targets are reached through December 31, 2006. The purchase agreement for one acquisition includes terms requiring additional consideration based on pre-tax earnings through September 30, 2007, with no maximum amount specified. Any contingent consideration accrued or payable in future years has been or will be recorded as an increase in goodwill.

When we acquire a new subsidiary, goodwill is either allocated to that particular subsidiary or, if there are synergies with other subsidiaries, allocated to the different reporting units based on their respective share of the estimated future cash flows. In 2005, we eliminated a tax valuation allowance, which we had established when we acquired a subsidiary in 2002, and reversed the subsidiary's remaining \$4.7 million of goodwill. In 2004, we recorded a \$5.6 million reduction in goodwill due to a tax refund as a result of an adjustment to pre-acquisition taxable income of an acquired subsidiary. The changes in goodwill were as follows:

	Insurance Company	Agency	Total
Balance at December 31, 2003 (As restated)	\$ 165,234	\$ 222,789	\$ 388,023
Additions:			
New acquisitions (As restated)	16,354	2,823	19,177
Earnouts	26,697	15,716	42,413
Transfer on reorganization	11,266	(11,266)	
Reduction for tax settlement	(4,201)	(1,381)	(5,582)
Balance at December 31, 2004	215,350	228,681	444,031
Additions:			
New acquisitions	59,881	1,628	61,509
Earnouts	24,162	7,922	32,084
Transfer on reorganization	45,353	(45,353)	
Reduction for tax adjustment	(4,677)		(4,677)
Balance at December 31, 2005	\$ 340,069	\$ 192,878	\$ 532,947

Disposition

In December 2003, we sold the business of our retail brokerage subsidiary, HCC Employee Benefits, Inc., for \$62.5 million in cash. We recognized a gain of \$52.7 million (\$30.1 million after-tax) in 2003 and additional gains of \$6.3 million (\$4.0 million after-tax) in 2004 and \$4.4 million (\$2.8 million after-tax) in 2005 from a contractual earnout, which is now completed. The after-tax earnings from discontinued operations and the gain on sale are reported as earnings from discontinued operations in the consolidated statements of earnings. Goodwill was reduced \$8.3 million as a result of the disposition. Discontinued operations for the year ended December 31, 2003 consisted of revenue of \$22.9 million and earnings before income tax expense of \$10.3 million. Earnings before income tax expense in 2003 excluded allocated general corporate overhead expenses of \$1.7 million.

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HCC Insurance Holdings, Inc. and Subsidiaries
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(4) INVESTMENTS

Substantially all of our fixed income securities are investment grade and 99% are rated A or better. The cost or amortized cost, gross unrealized gain or loss and estimated fair value of investments in fixed income securities, all of which are classified as available for sale, were as follows:

	Cost or amortized cost	Gross unrealized gain	Gross unrealized loss	Estimated fair value
December 31, 2005				
U.S. government	\$ 90,404	\$ 167	\$ (847)	\$ 89,724
States, municipalities and political subdivisions	1,138,499	10,109	(6,634)	1,141,974
Corporate fixed income securities	381,917	340	(6,675)	375,582
Asset-backed and mortgage-backed securities	361,456	562	(6,646)	355,372
Foreign securities	304,863	2,412	(1,303)	305,972
Total fixed income securities	\$ 2,277,139	\$ 13,590	\$ (22,105)	\$ 2,268,624
December 31, 2004				
U.S. government	\$ 87,652	\$ 688	\$ (214)	\$ 88,126
States, municipalities and political subdivisions	727,437	15,609	(1,696)	741,350
Corporate fixed income securities	374,130	4,644	(1,438)	377,336
Asset-backed and mortgage-backed securities	248,449	1,764	(1,510)	248,703
Foreign securities	244,753	3,176	(273)	247,656
Total fixed income securities	\$ 1,682,421	\$ 25,881	\$ (5,131)	\$ 1,703,171

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HCC Insurance Holdings, Inc. and Subsidiaries
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All fixed income securities were income producing during 2005, except for one security valued at \$0.4 million. The following table displays the gross unrealized losses and fair value of all investments that were in a continuous unrealized loss position for the periods indicated:

	Less than 12 months		12 months or more		Total	
	Unrealized		Unrealized		Unrealized	
	Fair value	losses	Fair value	losses	Fair value	losses
December 31, 2005						
U.S. government	\$ 50,108	\$ (449)	\$ 28,585	\$ (398)	\$ 78,693	\$ (847)
States, municipalities and political subdivisions	464,533	(4,614)	95,327	(2,020)	559,860	(6,634)
Corporate fixed income securities	119,762	(2,175)	194,057	(4,500)	313,819	(6,675)
Asset-backed and mortgage-backed securities	162,251	(2,078)	147,552	(4,568)	309,803	(6,646)
Foreign securities	72,365	(832)	43,465	(471)	115,830	(1,303)
Total securities	\$ 869,019	\$ (10,148)	\$ 508,986	\$ (11,957)	\$ 1,378,005	\$ (22,105)
December 31, 2004						
U.S. government	\$ 52,473	\$ (197)	\$ 489	\$ (17)	\$ 52,962	\$ (214)
States, municipalities and political subdivisions	170,352	(1,091)	27,500	(605)	197,852	(1,696)
Corporate fixed income securities	143,057	(1,170)	14,419	(268)	157,476	(1,438)
Asset-backed and mortgage-backed securities	140,536	(1,057)	12,096	(453)	152,632	(1,510)
Foreign securities	47,775	(252)	10,549	(21)	58,324	(273)
Total securities	\$ 554,193	\$ (3,767)	\$ 65,053	\$ (1,364)	\$ 619,246	\$ (5,131)

We regularly review our investments for possible impairments based on the criteria in Note 1. The determination that a security has incurred an other-than-temporary decline in value and the amount of any loss recognition requires management judgment and a continual review of our investments. We considered all of the losses at December 31, 2005 and 2004 shown above to be temporary based on the results of our review.

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HCC Insurance Holdings, Inc. and Subsidiaries
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The amortized cost and estimated fair value of fixed income securities at December 31, 2005, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The weighted average life of our asset-backed and mortgage-backed securities was 2.6 years.

	Amortized cost	Estimated fair value
Due in 1 year or less	\$ 147,717	\$ 146,924
Due after 1 year through 5 years	565,851	561,240
Due after 5 years through 10 years	468,075	467,542
Due after 10 years through 15 years	299,078	301,264
Due after 15 years	434,962	436,282
Securities with fixed maturities	1,915,683	1,913,252
Asset-backed and mortgage-backed securities	361,456	355,372
Total fixed income securities	\$ 2,277,139	\$ 2,268,624

At December 31, 2005, our domestic insurance companies had deposited fixed income securities of \$37.4 million (amortized cost of \$37.3 million) to meet the deposit requirements of various insurance departments. In addition, we had a deposit of fixed income securities of \$60.3 million (amortized cost of \$60.9 million) at Lloyd's of London, which serves as security for our participation in a Lloyd's syndicate. There are withdrawal and other restrictions on these deposits, but we direct how the deposits are invested and we earn interest on the funds.

The sources of net investment income were as follows:

	2005	2004	2003
Fixed income securities	\$ 77,842	\$ 55,929	\$ 40,927
Short-term investments	21,208	9,735	7,422
Other investments	3,615	1,366	488
Total investment income	102,665	67,030	48,837
Investment expense	(3,814)	(2,145)	(1,502)
Net investment income	\$ 98,851	\$ 64,885	\$ 47,335

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Realized pre-tax gains (losses) on the sale or write down of investments were as follows:

	Gains	Losses	Net
<u>Year ended December 31, 2005</u>			
Fixed income securities	\$ 3,562	\$ (1,475)	\$ 2,087
Other investments	156	(795)	(639)
Realized gain (loss)	\$ 3,718	\$ (2,270)	\$ 1,448

Year ended December 31, 2004

Fixed income securities	\$ 7,035	\$ (1,088)	\$ 5,947
Other investments	64	(189)	(125)
Realized gain (loss)	\$ 7,099	\$ (1,277)	\$ 5,822

Year ended December 31, 2003

Fixed income securities	\$ 3,113	\$ (1,230)	\$ 1,883
Other investments	40	(1,396)	(1,356)
Realized gain (loss)	\$ 3,153	\$ (2,626)	\$ 527

Unrealized pre-tax net gains (losses) on investments were as follows:

	2005	2004	2003
Fixed income securities	\$ (29,265)	\$ (9,288)	\$ (3,738)
Strategic and other investments	14,978	19,383	201
Net unrealized investment gains (losses)	\$ (14,287)	\$ 10,095	\$ (3,537)

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(5) REINSURANCE

In the normal course of business, our insurance companies cede a portion of their premium to domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although ceding for reinsurance purposes does not discharge the primary insurer from liability to its policyholder, our insurance companies participate in such agreements in order to limit their loss exposure, protect them against catastrophic loss and diversify their business. The following table presents the effect of such reinsurance transactions on our premium and loss and loss adjustment expense.

	Written premium	Earned premium	Loss and loss adjustment expense (As restated)
<u>Year ended December 31, 2005</u>			
Primary business	\$ 1,768,284	\$ 1,694,446	\$ 1,329,931
Reinsurance assumed	270,002	292,944	266,842
Reinsurance ceded	(537,062)	(617,402)	(677,076)
Net amounts	\$ 1,501,224	\$ 1,369,988	\$ 919,697

Year ended December 31, 2004

Primary business	\$ 1,674,075	\$ 1,557,806	\$ 966,163
Reinsurance assumed	301,078	302,496	322,992
Reinsurance ceded	(869,634)	(849,610)	(643,925)
Net amounts	\$ 1,105,519	\$ 1,010,692	\$ 645,230

Year ended December 31, 2003

Primary business	\$ 1,377,999	\$ 1,189,356	\$ 693,553
Reinsurance assumed	361,895	297,715	351,786
Reinsurance ceded	(874,392)	(748,799)	(557,339)
Net amounts	\$ 865,502	\$ 738,272	\$ 488,000

Ceding commissions netted with policy acquisition costs in the consolidated statements of earnings were \$96.0 million in 2005, \$113.5 million in 2004 and \$113.8 million in 2003.

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The table below shows the components of reinsurance recoverables reported in our consolidated balance sheets.

	2005 (As restated)	2004
Reinsurance recoverable on paid losses	\$ 93,837	\$ 94,535
Reinsurance recoverable on outstanding losses	636,225	509,512
Reinsurance recoverable on incurred but not reported losses	644,062	520,404
Reserve for uncollectible reinsurance	(12,141)	(20,425)
Total reinsurance recoverables	\$ 1,361,983	\$ 1,104,026

Our U.S. domiciled insurance companies require reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize their reinsurance obligations due to us. The table below shows the amounts of letters of credit and cash deposits held by us as collateral, plus other credits available for potential offset at December 31, 2005 and 2004.

	2005	2004
Payables to reinsurers	\$ 291,826	\$ 350,514
Letters of credit	350,135	265,152
Cash deposits	64,150	68,307
Total credits	\$ 706,111	\$ 683,973

The tables below present the calculation of net reserves, net unearned premium and net deferred policy acquisition costs at December 31, 2005 and 2004.

	2005 (As restated)	2004 (As restated)
Loss and loss adjustment expense payable	\$ 2,813,720	\$ 2,089,199
Reinsurance recoverable on outstanding losses	(636,225)	(509,512)
Reinsurance recoverable on incurred but not reported losses	(644,062)	(520,404)
Net reserves	\$ 1,533,433	\$ 1,059,283
Unearned premium	\$ 807,109	\$ 741,706
Ceded unearned premium	(239,416)	(311,973)
Net unearned premium	\$ 567,693	\$ 429,733
Deferred policy acquisition costs	\$ 156,253	\$ 139,199
Deferred ceding commissions	(67,886)	(93,480)
Net deferred policy acquisition costs	\$ 88,367	\$ 45,719

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In order to reduce our exposure to reinsurance credit risk, we evaluate the financial condition of our reinsurers and place our reinsurance with a diverse group of companies and syndicates, which we believe to be financially sound. The following table shows reinsurance balances relating to our reinsurers with a net recoverable balance greater than \$25.0 million at December 31, 2005 and 2004. The total recoverables column includes paid losses recoverable, outstanding losses recoverable, incurred but not reported losses recoverable and ceded unearned premium. The total credits column includes letters of credit, cash deposits and other payables.

Reinsurer	Rating	Location	Total recoverables	Total credits	Net recoverables
<u>December 31, 2005</u>					
Hannover Rueckversicherungs AG	A	Germany	\$ 147,589	\$ 28,232	\$ 119,357
Lloyd's Syndicate Number 0033	A-	United Kingdom	43,756	681	43,075
Arch Reinsurance Ltd.	A-	Bermuda	52,226	11,544	40,682
Everest Reinsurance Company	A+	Delaware	53,344	13,741	39,603
Odyssey America Reinsurance Corp.	A	Connecticut	39,973	3,474	36,499
Swiss Reinsurance America Corp.	A+	New York	43,470	7,749	35,721
Platinum Underwriters Reinsurance Co.	A	Maryland	38,159	4,422	33,737
ACE Property & Casualty Insurance Co.	A+	Pennsylvania	31,139	2,036	29,103
Harco National Insurance Company	A-	Illinois	29,873	3,657	26,216
Transatlantic Reinsurance Company	A+	New York	26,661	1,331	25,330
Lloyd's Syndicate Number 0958	B	United Kingdom	26,332	1,091	25,241

December 31, 2004

Hannover Rueckversicherungs AG	A	Germany	\$ 66,961	\$ 21,261	\$ 45,700
Everest Reinsurance Company	A+	Delaware	55,443	12,139	43,304
Harco National Insurance Company	A-	Illinois	51,067	8,879	42,188
Lloyd's Syndicate Number 2488	A-	United Kingdom	41,460	2,941	38,519
Lloyd's Syndicate Number 0033	A-	United Kingdom	31,560	574	30,986
Lloyd's Syndicate Number 1101	B-	United Kingdom	31,663	774	30,889
Lloyd's Syndicate Number 1206	B-	United Kingdom	31,242	358	30,884
Odyssey America Reinsurance Corp.	A	Connecticut	29,551	2,637	26,914
Platinum Underwriters Reinsurance Co.	A	Maryland	36,658	10,669	25,989

Ratings for companies are published by A.M. Best Company, Inc. Ratings for individual Lloyd's syndicates are published by Moody's Investors Services, Inc. Lloyd's of London is an insurance and reinsurance marketplace composed of many independent underwriting syndicates financially supported by a central trust fund. Lloyd's of

London is rated A by A.M. Best Company, Inc.

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Certain reinsurers have delayed or suspended payment of amounts recoverable under reinsurance contracts to which we are a party. We limit our liquidity 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 consolidated balance sheets. 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 litigation or arbitration. We resolved certain arbitrations in 2005; amounts with respect to the remaining arbitration and litigation proceedings that we initiated are not material.

We have a reserve of \$12.1 million at December 31, 2005 for potential collectibility issues related to reinsurance recoverables, including disputed amounts and associated expenses. While we believe the reserve is adequate based on information currently available, conditions may change or additional information might be obtained which may require us to change the reserve in the future. 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. We assessed the collectibility of our year-end recoverables related to our hurricane losses and believe the recoverables are collectible based on currently available information.

HCC Life Insurance Company previously sold its entire block of individual life insurance and annuity business to Swiss Re Life & Health America, Inc. (rated A+ by A.M. Best Company, Inc.) in the form of an indemnity reinsurance contract. Ceded life and annuity benefits amounted to \$73.4 million and \$74.6 million at December 31, 2005 and 2004, respectively.

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(6) LIABILITY FOR UNPAID LOSS AND LOSS ADJUSTMENT EXPENSE

The following table provides a reconciliation of the liability for unpaid loss and loss adjustment expense payable.

	2005 (As restated)	2004 (As restated)	2003 (As restated)
Reserves for loss and loss adjustment expense payable at beginning of year	\$ 2,089,199	\$ 1,525,313	\$ 1,158,915
Less reinsurance recoverables	1,029,916	820,113	700,213
Net reserves at beginning of year	1,059,283	705,200	458,702
Net reserve addition from acquisition of subsidiaries	12,491	11,647	5,587
Incurred loss and loss adjustment expense:			
Provision for loss and loss adjustment expense for claims occurring in current year	894,303	614,752	464,886
Increase in estimated loss and loss adjustment expense for claims occurring in prior years	25,394	30,478	23,114
Incurred loss and loss adjustment expense	919,697	645,230	488,000
Loss and loss adjustment expense payments for claims occurring during:			
Current year	285,814	161,117	110,528
Prior years	172,224	141,677	136,561
Loss and loss adjustment expense payments	458,038	302,794	247,089
Net reserves at end of year	1,533,433	1,059,283	705,200
Plus reinsurance recoverables	1,280,287	1,029,916	820,113
Reserves for loss and loss adjustment expense at end of year	\$ 2,813,720	\$ 2,089,199	\$ 1,525,313

We had net loss and loss adjustment expense adverse development relating to prior year losses of \$25.4 million in 2005, \$30.5 million in 2004 and \$23.1 million in 2003. The 2005 development resulted from a commutation charge of \$26.0 million and a net redundancy of \$0.6 million from all other sources. Our 2004 deficiency included a charge of \$27.3 million related to adverse development in certain assumed accident and health business, and we had a net deficiency of \$3.2 million from all other sources. The 2003 development resulted from a commutation charge of \$28.8 million, partially offset by a net redundancy of \$5.7 million from all other sources. Deficiencies and redundancies in the reserves occur as we continually review our loss reserves with our actuaries, increasing or reducing loss reserves as a result of such reviews and as losses are finally settled and claims exposures are reduced. We believe we have provided for all material net incurred losses.

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We have no material exposure to environmental pollution losses. Our largest insurance company subsidiary only began writing business in 1981 and its policies normally contain pollution exclusion clauses which limit pollution coverage to sudden and accidental losses only, thus excluding intentional dumping and seepage claims. Policies issued by our other insurance company subsidiaries do not have significant environmental exposures because of the types of risks covered. Therefore, we do not expect to experience any material loss development for environmental pollution claims. Likewise, we have no material exposure to asbestos claims.

(7) NOTES PAYABLE

Notes payable at December 31, 2005 and 2004 are shown in the table below. The aggregate estimated fair value of our 1.30% and 2.00% convertible notes (\$399.5 million and \$332.8 million at December 31, 2005 and 2004, respectively) is based on quoted market prices. The estimated fair value of our other debt is based on current rates offered to us for debt with similar terms and approximates the carrying value at both balance sheet dates.

	2005	2004
1.30% Convertible Notes	\$ 125,000	\$ 125,000
2.00% Convertible Exchange Notes	172,400	172,442
\$200.0 million Revolving Loan Facility		
Other debt	12,143	13,835
Total notes payable	\$ 309,543	\$ 311,277

Our 1.30% Convertible Notes are due in 2023. We pay interest semi-annually on April 1 and October 1. Each one thousand dollar principal amount of notes is convertible into 44.1501 shares of our common stock, which represents an initial conversion price of \$22.65 per share. The initial conversion price is subject to change under certain conditions. Holders may surrender notes for conversion 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% (\$29.45 per share) of the conversion price per share of our common stock. We must settle any conversions by paying cash for the principal amount of the notes and issuing our common stock for the value of the conversion premium. We can redeem the notes for cash at any time on or after April 1, 2009. Holders may require us to repurchase the notes on April 1, 2009, 2014 or 2019, or if a change in control of HCC Insurance Holdings, Inc. occurs on or before April 1, 2009. The repurchase price to settle any such put or change in control provisions will equal the principal amount of the notes plus accrued and unpaid interest and will be paid in cash.

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Our 2.00% Convertible Exchange Notes are due in 2021. We pay interest semi-annually on March 1 and September 1. In November 2004, we exchanged substantially all of our 2.00% Convertible Notes for 2.00% Convertible Exchange Notes, which have terms economically similar to the original notes. We recorded no gain or loss for the debt exchange and expensed all debt issuance costs. Each one thousand dollar principal amount is convertible into 46.8823 shares of our common stock, which represents an initial conversion price of \$21.33 per share. The initial conversion price is subject to change under certain conditions. Holders may surrender notes for conversion if, as of the last day of the preceding calendar quarter, the closing sale price of our common stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of that quarter is more than 120% (\$25.60 per share) of the conversion price per share of our common stock. We must settle any conversion by paying cash for the principal amount of the notes and issuing our common stock for the value of the conversion premium. We can redeem the notes for cash at any time on or after September 1, 2007. Holders may require us to repurchase the notes on September 1, 2007, 2011 or 2016, or if a change in control of HCC Insurance Holdings, Inc. occurs on or before September 1, 2007. The repurchase price to settle any such put or change in control provisions will equal the principal amount of the notes plus accrued and unpaid interest and will be paid in cash.

Our \$200.0 million Revolving Loan Facility allows us to borrow up to the maximum allowed by the facility on a revolving basis until the facility expires on November 30, 2009. The facility is collateralized in part by the pledge of our insurance companies' stock and guaranties entered into by our underwriting agencies and reinsurance brokers. The facility agreement contains certain restrictive covenants which we believe are typical for similar financing arrangements.

In 2006, we entered into a \$34.0 million Standby Letter of Credit Facility, which allows us to replace a portion of our funds at Lloyd's of London with standby letters of credit. Any letters of credit issued under the Standby Letter of Credit Facility will be unsecured commitments of HCC. The Standby Letter of Credit Facility contains standard restrictive covenants, which in many cases are identical to or incorporate by reference the restrictive covenants from our Revolving Loan Facility.

At December 31, 2005, certain of our subsidiaries maintained revolving lines of credit with a bank in the combined maximum amount of \$45.2 million available through November 30, 2009. Advances under the lines of credit are limited to amounts required to fund draws, if any, on letters of credit issued by the bank on behalf of the subsidiaries and short-term direct cash advances. The lines of credit are collateralized by securities having an aggregate market value of up to \$56.5 million, the actual amount of collateral at any one time being 125% of the aggregate amount outstanding. Interest on the lines is payable at the bank's prime rate of interest (7.25% at December 31, 2005) for draws on the letters of credit and either prime or prime less 1% on short-term cash advances. At December 31, 2005, letters of credit totaling \$16.7 million had been issued to insurance companies by the bank on behalf of our subsidiaries, with total securities of \$20.9 million collateralizing the lines.

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(8) INCOME TAXES

At December 31, 2005 and 2004, we had current income taxes payable of \$21.3 million and \$18.1 million, respectively, included in accounts payable and accrued liabilities in the consolidated balance sheets.

The following table summarizes the differences between our effective tax rate for financial statement purposes and the Federal statutory rate:

	2005 (As restated) 35%	2004 (As restated) 35%	2003 (As restated) 35%
Statutory tax rate			
Federal tax on continuing operations at statutory rate	\$ 95,413	\$ 84,223	\$ 57,653
Nontaxable municipal bond interest and dividends received deduction	(12,267)	(7,076)	(4,126)
Non-deductible compensation	969	775	1,481
Other non deductible expenses	816	394	725
State income taxes, net of federal tax benefit	3,591	2,962	3,164
Foreign income taxes	15,024	12,639	15,076
Foreign tax credit	(14,981)	(12,456)	(14,599)
Dividends received deduction on repatriated foreign earnings	(2,784)		
Other, net	(1,604)	479	8
Income tax expense from continuing operations	\$ 84,177	\$ 81,940	\$ 59,382
Effective tax rate, continuing operations	30.9%	34.1%	36.1%
Federal tax on discontinued operations at statutory rate	\$ 1,556	\$ 2,211	\$ 22,041
Book over tax basis in stock of subsidiary			2,896
State income taxes, net of federal tax benefit, and other	130	102	1,352
Income tax expense on discontinued operations	\$ 1,686	\$ 2,313	\$ 26,289
Effective tax rate, discontinued operations	37.9%	36.6%	41.7%
Total income tax expense	\$ 85,863	\$ 84,253	\$ 85,671
Total effective tax rate	31.0%	34.1%	37.6%

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The components of income tax expense were as follows:

	2005 (As restated)	2004 (As restated)	2003 (As restated)
Federal current	\$ 69,113	\$ 82,856	\$ 57,961
Federal deferred	(5,485)	(18,112)	(16,359)
Total federal	63,628	64,744	41,602
State current	4,266	7,065	7,167
State deferred	1,259	(2,508)	(1,356)
Total state	5,525	4,557	5,811
Foreign current	15,155	11,462	11,285
Foreign deferred	(131)	1,177	684
Total foreign	15,024	12,639	11,969
Income tax expense from continuing operations	\$ 84,177	\$ 81,940	\$ 59,382
Federal current	\$ 3,528	\$ 1,898	\$ 25,038
Federal deferred	(2,042)	271	(815)
Total federal	1,486	2,169	24,223
State current	475	110	1,792
State deferred	(275)	34	274
Total state	200	144	2,066
Income tax expense from discontinued operations	\$ 1,686	\$ 2,313	\$ 26,289
Total income tax expense	\$ 85,863	\$ 84,253	\$ 85,671

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HCC Insurance Holdings, Inc. and Subsidiaries
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The net deferred tax asset is included in other assets in our consolidated balance sheets. The composition of deferred tax assets and liabilities at December 31, 2005 and 2004 was as follows:

	2005 (As restated)	2004 (As restated)
Excess of financial unearned premium over tax	\$ 32,932	\$ 27,238
Effect of loss reserve discounting and salvage and subrogation accrual for tax	34,903	21,341
Excess of financial accrued expenses over tax	23,264	20,602
Allowance for bad debts, not deductible for tax	7,047	7,925
Federal tax net operating loss carryforwards	1,581	2,354
State tax net operating loss carryforwards	3,910	4,103
Foreign branch net operating loss carryforwards	3,244	1,194
Valuation allowance	(10,293)	(17,358)
Total deferred tax assets	96,588	67,399
Unrealized gain on increase in value of securities available for sale (shareholders' equity)	9,927	14,086
Deferred policy acquisition costs, net of ceding commissions, deductible for tax	11,087	3,970
Amortizable goodwill for tax	18,953	13,012
Book basis in net assets of foreign subsidiaries in excess of tax	8,032	5,354
Property and equipment depreciation and other items	6,519	5,771
Total deferred tax liabilities	54,518	42,193
Net deferred tax asset	\$ 42,070	\$ 25,206

Changes in the valuation allowance account applicable to deferred tax assets result primarily from the acquisition and expiration of net operating losses and other tax attributes related to acquired subsidiaries. In 2005, we eliminated a valuation allowance that we had established when we acquired a subsidiary in 2002. Changes in the valuation allowance were as follows:

	2005 (As restated)	2004 (As restated)	2003 (As restated)
Balance at beginning of year	\$ 17,358	\$ 17,444	\$ 11,547
Increase due to acquisitions		611	4,900
Reduction related to 2002 acquisition	(5,511)		
Other	(1,554)	(697)	997
Balance at end of year	\$ 10,293	\$ 17,358	\$ 17,444

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HCC Insurance Holdings, Inc. and Subsidiaries
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At December 31, 2005, we have Federal and state tax net operating loss carryforwards of approximately \$13.8 million and \$61.5 million, respectively, which will expire in varying amounts through 2025. Future use of certain carryforwards is subject to statutory limitations due to prior changes of ownership. Approximately \$9.3 million of Federal tax loss carryforwards relate to our foreign insurance companies and can only be used against future taxable income of those entities. We have recorded valuation allowances of \$1.6 million against our Federal loss carryforwards, substantially all of which would reduce goodwill if the carryforwards are realized, and \$3.1 million against our state loss carryforwards. Based on our history of taxable income in our domestic insurance and other operations and our projections of future taxable income in our domestic and foreign insurance operations, we believe it is more likely than not that the deferred tax assets related to our loss carryforwards, for which there are no valuation allowances, will be realized.

The American Jobs Creation Act of 2004 provided U.S. corporations with a one time opportunity to repatriate earnings of certain foreign subsidiaries at materially reduced tax rates by allowing a temporary dividends received deduction if the repatriated amounts were reinvested in the United States in accordance with the provision of the law. We had previously recorded deferred taxes on the undistributed earnings of our foreign subsidiaries at the U.S. statutory rate of 35%. In 2005, we repatriated \$14.2 million from certain foreign subsidiaries and recognized a \$2.8 million tax benefit in accordance with FASB Staff Position No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*.

(9) SHAREHOLDERS EQUITY

In 2005 and 2004, we sold 4.7 million and 4.5 million shares of our common stock in public offerings at prices of \$32.05 and \$22.17 per share, respectively. Net proceeds from the offerings totaled \$150.0 million in 2005 and \$96.7 million in 2004, after deducting the underwriting discount and offering expenses. In 2005, we used \$108.0 million of the proceeds to make capital contributions to our insurance company subsidiaries and used the remainder for acquisitions. In 2004, we used \$75.0 million of the proceeds to make a capital contribution to an insurance company subsidiary and \$17.0 million to pay down bank debt.

At December 31, 2005, 12.5 million shares of our common stock were reserved for the exercise of options, of which 8.2 million shares were reserved for options previously granted and 4.3 million shares were reserved for future issuances.

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The components of accumulated other comprehensive income in our consolidated balance sheets were as follows:

	Unrealized investment gain (loss)	Foreign currency translation (As restated)	Accumulated other comprehensive income (As restated)
Balance at December 31, 2002	\$ 21,649	\$ (884)	\$ 20,765
Net change for year	(2,305)	6,451	4,146
Balance at December 31, 2003	19,344	5,567	24,911
Net change for year	6,437	6,287	12,724
Balance at December 31, 2004	25,781	11,854	37,635
Net change for year	(8,862)	(9,699)	(18,561)
Balance at December 31, 2005	\$ 16,919	\$ 2,155	\$ 19,074

U.S. insurance companies are limited to the amount of dividends they can pay to their parent by the laws of their state of domicile. The maximum dividends that our direct domestic subsidiaries can pay in 2006 without special permission is \$90.3 million. One of our insurance companies cannot pay a dividend in 2006 without special permission because it paid a special approved dividend in 2005.

(10) EARNINGS PER SHARE

The following table details the numerator and denominator used in the earnings per share calculations.

	2005	2004	2003
Net earnings (As restated)	\$ 191,192	\$ 162,699	\$ 142,027
Weighted average common shares outstanding	105,463	97,257	94,919
Dilutive effect of outstanding options (determined using the treasury stock method)	1,659	1,569	1,657
Dilutive effect of convertible debt (determined using the treasury stock method)	2,315		
Weighted average common shares and potential common shares outstanding	109,437	98,826	96,576
Anti-dilutive stock options not included in treasury stock method computation	118	6	306

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(11) STOCK OPTIONS

Our stock option plans, the 2004 Flexible Incentive Plan and 2001 Flexible Incentive Plan, are administered by the Compensation Committee of the Board of Directors. Options granted under these plans may be used to purchase one share of our common stock. Options cannot be repriced downward under these plans.

The following table details our stock option activity during the three years ended December 31, 2005.

	2005		2004		2003	
	Number of shares	Average exercise price	Number of shares	Average exercise price	Number of shares	Average exercise price
Outstanding, beginning of year	7,178	\$ 15.99	8,291	\$ 14.99	9,557	\$ 13.99
Granted at market value	143	23.27	382	20.26	23	14.99
Granted below market value	3,671	25.72	662	20.27	690	16.35
Exercised	(2,459)	14.91	(1,494)	13.77	(1,889)	10.46
Forfeited and expired	(314)	17.97	(663)	15.92	(90)	14.35
Outstanding, end of year	8,219	20.71	7,178	15.99	8,291	14.99
Exercisable, end of year	1,766	16.90	2,919	15.26	2,807	14.41

Options outstanding and exercisable at December 31, 2005 were as follows:

Range of exercise prices	Options outstanding			Options exercisable	
	Number of shares	Average remaining contractual life	Average exercise price	Number of shares	Average exercise price
Under \$16.36	1,963	3.5 years	\$ 14.50	562	\$ 14.54
\$16.36-\$20.05	2,115	3.4 years	17.64	1,000	17.34
\$20.06-\$25.50	1,156	4.8 years	22.80	204	21.22
Over \$25.50	2,985	5.6 years	26.17		
Total options	8,219	4.4 years	20.71	1,766	16.90

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(12) SEGMENT AND GEOGRAPHIC DATA

We classify our activities into the following three operating business segments based on services provided: 1) insurance company, 2) agency and 3) other operations. See Note 1 for a description of the principal subsidiaries included in and the services provided by our insurance company and agency segments. Our other operations segment includes insurance-related investments that we make periodically. Corporate includes general corporate operations and those minor operations not included in a segment. Inter-segment revenue consists primarily of fee and commission income of our agency segment charged to our insurance company segment. Inter-segment pricing (either flat rate fees or as a percentage of premium) approximates what is charged to unrelated parties for similar services. Effective January 1, 2005, we consolidated our largest underwriting agency (agency segment) into HCC Life Insurance Company (insurance company segment) and, in 2006, we intend to consolidate our London underwriting agency (agency segment) into HCC International Insurance Company (insurance segment).

The performance of each segment is evaluated by our management based on net earnings. Net earnings is calculated after tax and after all corporate expense allocations, interest expense on debt incurred at the purchase date, and intercompany eliminations have been charged or credited to our individual segments. All stock-based compensation is included in the corporate segment since it is not included in management's evaluation of the other segments. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated.

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	Insurance Company	Agency	Other Operations	Corporate	Total
<u>Year ended December 31, 2005 (As restated)</u>					
Revenue:					
Domestic	\$ 1,216,894	\$ 62,111	\$ 35,324	\$ 6,784	\$ 1,321,113
Foreign	281,697	39,878			321,575
Inter-segment	158	86,877			87,035
Total segment revenue	\$ 1,498,749	\$ 188,866	\$ 35,324	\$ 6,784	1,729,723
Inter-segment eliminations					(87,035)
Consolidated total revenue					\$ 1,642,688
Net earnings:					
Domestic	\$ 119,634	\$ 31,158	\$ 22,605	\$ 352	\$ 173,749
Foreign	6,488	7,294			13,782
Total segment net earnings	\$ 126,122	\$ 38,452	\$ 22,605	\$ 352	187,531
Inter-segment eliminations					901
Earnings from discontinued operations, net of income taxes					2,760
Consolidated net earnings					\$ 191,192
Other items:					
Net investment income	\$ 88,397	\$ 7,437	\$ 794	\$ 2,223	\$ 98,851
Depreciation and amortization	4,825	7,381	459	1,982	14,647
Interest expense (benefit)	445	9,173	699	(2,633)	7,684
Capital expenditures	2,134	3,046	716	4,937	10,833
Income tax expense (benefit)	49,327	26,174	10,282	(2,034)	83,749
Inter-segment eliminations					428
Consolidated income tax expense on continuing operations					\$ 84,177

For 2005, earnings before income taxes were \$257.8 million for our domestic subsidiaries (including discontinued operations) and \$19.3 million for our foreign subsidiaries and branches. During 2005, the insurance company segment recorded after-tax losses of \$58.2 million due to the 2005 hurricanes and \$16.9 million due to commutations.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

	Insurance Company	Agency	Other Operations	Corporate	Total
<u>Year ended December 31, 2004 (As restated)</u>					
Revenue:					
Domestic	\$ 884,857	\$ 86,806	\$ 13,020	\$ 4,721	\$ 989,404
Foreign	250,718	44,485			295,203
Inter-segment	553	95,475			96,028
Total segment revenue	\$ 1,136,128	\$ 226,766	\$ 13,020	\$ 4,721	1,380,635
Inter-segment eliminations					(96,028)
Consolidated total revenue					\$ 1,284,607
Net earnings (loss):					
Domestic	\$ 84,522	\$ 37,438	\$ 7,871	\$ (4,243)	\$ 125,588
Foreign	24,764	16,208			40,972
Total segment net earnings (loss)	\$ 109,286	\$ 53,646	\$ 7,871	\$ (4,243)	\$ 166,560
Inter-segment eliminations					(7,865)
Earnings from discontinued operations, net of income taxes					4,004
Consolidated net earnings					\$ 162,699
Other items:					
Net investment income	\$ 59,073	\$ 3,559	\$ 1,236	\$ 1,017	\$ 64,885
Depreciation and amortization	4,568	9,729	531	1,311	16,139
Interest expense (benefit)	856	8,491	768	(1,741)	8,374
Capital expenditures	3,451	1,984	16	2,885	8,336
Income tax expense	51,404	31,440	2,964	1,625	87,433
Inter-segment eliminations					(5,493)
Consolidated income tax expense on continuing operations					\$ 81,940

For 2004, earnings before income taxes were \$189.1 million for our domestic subsidiaries (including discontinued operations) and \$57.9 million for our foreign subsidiaries and branches. During 2004, the insurance company segment recorded an after-tax loss of \$21.5 million due to the 2004 hurricanes.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

	Insurance Company	Agency	Other Operations	Corporate	Total
<u>Year ended December 31, 2003 (As restated)</u>					
Revenue:					
Domestic	\$ 606,469	\$ 65,484	\$ 11,725	\$ 790	\$ 684,468
Foreign	219,578	37,918			257,496
Inter-segment		96,869			96,869
Total segment revenue	\$ 826,047	\$ 200,271	\$ 11,725	\$ 790	1,038,833
Inter-segment eliminations					(96,869)
Consolidated total revenue					\$ 941,964
Net earnings (loss):					
Domestic	\$ 56,935	\$ 37,663	\$ 6,014	\$ (7,787)	\$ 92,825
Foreign	18,335	12,065			30,400
Total segment net earnings (loss)	\$ 75,270	\$ 49,728	\$ 6,014	\$ (7,787)	123,225
Inter-segment eliminations					(17,882)
Earnings from discontinued operations, net of income taxes					36,684
Consolidated net earnings					\$ 142,027
Other items:					
Net investment income *	\$ 42,345	\$ 3,796	\$ 224	\$ 970	\$ 47,335
Depreciation and amortization *	3,271	6,283	664	2,435	12,653
Interest expense (benefit)	62	7,877	770	(1,256)	7,453
Capital expenditures *	2,618	2,997		16,047	21,662
Income tax expense	35,478	33,075	2,699	(993)	70,259
Inter-segment eliminations					(10,877)
Consolidated income tax expense on continuing operations					\$ 59,382

* Excludes immaterial amounts related to discontinued operations.

For 2003, earnings before income taxes were \$180.5 million for our domestic subsidiaries (including discontinued operations) and \$47.2 million for our foreign subsidiaries and branches. During 2003, the insurance company segment recorded an after-tax loss of \$18.7 million due to a commutation.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

The following tables present selected revenue items by line of business:

	2005	2004	2003
Diversified financial products	\$ 531,136	\$ 310,809	\$ 123,562
Group life, accident and health	504,382	343,913	290,009
Aviation	136,197	127,248	97,536
London market account	93,017	111,341	137,572
Other specialty lines	97,721	69,089	12,443
Discontinued lines	7,535	48,292	77,150
Net earned premium	\$ 1,369,988	\$ 1,010,692	\$ 738,272
	(As restated)	(As restated)	
Property and casualty	\$ 113,725	\$ 127,502	\$ 85,244
Accident and health	18,903	56,300	57,371
Fee and commission income	\$ 132,628	\$ 183,802	\$ 142,615

Assets by business segment and geographic location are shown in the following tables.

	Insurance Company	Agency	Other Operations	Corporate	Total
<u>December 31, 2005 (As restated)</u>					
Domestic	\$ 3,981,574	\$ 634,263	\$ 170,620	\$ 152,652	\$ 4,939,109
Foreign	1,464,306	625,385			2,089,691
Total assets	\$ 5,445,880	\$ 1,259,648	\$ 170,620	\$ 152,652	\$ 7,028,800
<u>December 31, 2004 (As restated)</u>					
Domestic	\$ 3,262,639	\$ 710,386	\$ 109,642	\$ 117,317	\$ 4,199,984
Foreign	1,032,089	668,495			1,700,584
Total assets	\$ 4,294,728	\$ 1,378,881	\$ 109,642	\$ 117,317	\$ 5,900,568

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

(13) COMMITMENTS AND CONTINGENCIES

Litigation

We are 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 over contractual relationships 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.

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 appointment of the liquidator. The disputed payments, totaling \$10.3 million, were made by the now insolvent reinsurer in connection with a commutation agreement. Our understanding is that such litigation is similar to other actions brought by the liquidator. We continue to vigorously contest the action.

Although the ultimate outcome of the matters mentioned above 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 these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Catastrophe Exposure

We write business in areas exposed to catastrophic losses and have significant exposures to this type of loss in California, the Atlantic Coast of the United States, certain United States Gulf Coast states (particularly Louisiana, Florida and Texas), the Caribbean and Mexico. We assess our overall exposures to a single catastrophic event and apply procedures to ascertain our probable maximum loss from any single event. We maintain reinsurance protection that we believe is sufficient to cover any foreseeable event.

Indemnifications

In conjunction with the sales of business assets and subsidiaries, we have provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to our responsibilities to perform under the sales contracts. Other indemnifications agree to reimburse the purchasers for taxes or ERISA-related amounts, if any, assessed after the sale date but related to pre-sale activities. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires on December 31, 2009.

We accrue a loss related to our indemnifications when a valid claim is made by a buyer and we believe we have potential exposure. We currently have several claims under indemnifications that cover certain net losses alleged to have been incurred in periods prior to our sale of certain subsidiaries or otherwise alleged to be covered under indemnification agreements related to such sales. As of December 31, 2005, we have recorded a liability of \$20.7 million and have provided \$8.1 million of letters of credit to cover our obligations or anticipated payments

under these indemnifications.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

Terrorist Exposure

Under the Federal Terrorism Risk Extension Insurance Act of 2005, we are required to offer terrorism coverage to our commercial policyholders in certain lines of business written in the United States, for which we may, when warranted, charge an additional premium. The policyholders may or may not accept such coverage. This law also established a deductible that each insurer would have to meet before U.S. Federal reimbursement would occur. For 2006, our deductible is approximately \$91.9 million. The Federal government would provide reimbursement for 90% of any additional covered losses in 2006 up to the maximum amount set out in the Act. Currently, the law expires on December 31, 2007.

Leases

We lease administrative office facilities and transportation equipment under long-term non-cancelable operating leases that expire at various dates through 2025. The agreements generally require us to pay rent, utilities, real estate taxes, insurance and repairs. We recognize rent expense on a straight-line basis over the term of the lease, including free-rent periods. Rent expense under operating leases totaled \$9.8 million in 2005, \$9.3 million in 2004 and \$8.6 million in 2003.

At December 31, 2005, future minimum rental payments required under long-term, non-cancelable operating leases, excluding certain expenses payable by us, were as follows:

Years ended December 31,	
2006	\$ 10,582
2007	10,139
2008	8,797
2009	6,461
2010	5,689
Thereafter	17,455
Total future minimum rental payments	\$ 59,123

(14) RELATED PARTY TRANSACTIONS

We have strategic investments in a limited liability corporation and a related entity for which one of our Directors previously served in management and advisory roles. The carrying value of these investments was \$15.1 million at December 31, 2004. Income and realized gains (losses) from these investments totaled \$0.5 million in 2004 and \$(0.6) million in 2003. An entity that this Director is affiliated with serves as the investment manager for fixed income securities valued at \$207.9 million and \$203.6 million at December 31, 2005 and 2004, respectively. During 2005 and 2004, we paid \$0.2 million and \$0.1 million, respectively, in investment management fees to this entity. We also have entered into an agreement with an entity owned by our Chairman and Chief Executive Officer, who is also a Director, pursuant to which we rent equipment and facilities to provide transportation services to our employees, our Directors and our clients. We provide our own employees to operate the equipment and pay all expenses related to its operation. We paid rentals of \$1.1 million in 2005, \$1.0 million in 2004 and \$1.2 million in 2003.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

In 2004, we owned an interest in a company at a level that the company qualified as a related party. That interest has now been reduced below the qualifying amount. In 2004, we recorded \$3.2 million of other operating income related to this company and ceded \$9.1 million of written premium to and assumed \$61.5 million of written premium from this company.

At December 31, 2005 and 2004, we accrued \$32.3 million and \$35.9 million, respectively, for amounts owed to former owners of businesses we acquired, who now are officers of certain of our subsidiaries. These accruals represent amounts due under the terms of various acquisition agreements. We paid \$35.1 million in 2005, \$41.0 million in 2004 and \$15.2 million in 2003 related to such agreements.

We own equity interests ranging from 20% to 31% in three companies for which we use the equity method of accounting. During 2005, we acquired the remaining interest in two other companies we owned a minority interest in and included 100% of their earnings in our consolidated financial statements beginning on the effective date of the acquisitions. We recorded gross written premium from business originating at the five companies (until the acquisition date for the two companies that are now subsidiaries) of \$40.2 million in 2005, \$21.7 million in 2004 and \$2.1 million in 2003. During 2005 and 2004, we also ceded written premium of \$8.0 million and \$5.6 million, respectively, to one of these companies under a quota share reinsurance agreement.

(15) STATUTORY INFORMATION

Our insurance companies file financial statements prepared in accordance with statutory accounting practices prescribed or permitted by domestic or foreign insurance regulatory authorities. The differences between statutory financial statements and financial statements prepared in accordance with generally accepted accounting principles vary between domestic and foreign jurisdictions.

Statutory policyholders' surplus and net income, after intercompany eliminations, included in those companies' respective filings with regulatory authorities were as follows:

	2005	2004	2003
Statutory policyholders' surplus	\$ 1,110,268	\$ 844,851	\$ 591,889
Statutory net income	112,231	85,843	54,784

The 2005 statutory net income was reduced \$58.2 million due to the 2005 hurricanes and \$20.3 million due to commutations. The 2004 statutory net income was reduced \$21.5 million due to the 2004 hurricanes. The 2003 statutory net income was reduced \$18.7 million due to a commutation.

The statutory surplus of each of our insurance companies is significantly in excess of regulatory risk-based capital requirements.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

(16) SUPPLEMENTAL INFORMATION

Supplemental cash flow information was as follows:

	2005	2004	2003
Cash received from commutations	\$ 180,789	\$ 79,462	\$ 48,983
Income taxes paid	78,309	112,392	70,573
Interest paid	6,168	7,219	6,174
Dividends declared but not paid at year end	8,310	5,783	4,800

The unrealized gain or loss on securities available for sale, deferred taxes related thereto and the issuance of our common stock for the purchase of subsidiaries are non-cash transactions that have been included as direct increases or decreases in our consolidated shareholders' equity.

(17) QUARTERLY FINANCIAL DATA (UNAUDITED)

The quarterly financial data has been restated for the adjustments discussed in Note 2.

	Fourth quarter 2005			Fourth quarter 2004		
	As previously		As restated	As previously		As restated
	reported	Adjustments		reported	Adjustments	
Total revenue	\$ 447,796	\$ (201)	\$ 447,595	\$ 365,669	\$ 1,388	\$ 367,057
Net earnings	\$ 66,534	\$ (1,498)	\$ 65,036	\$ 56,239	\$ 1,079	\$ 57,318
Basic earnings per share data:						
Earnings per share	\$ 0.62	\$ (0.02)	\$ 0.60	\$ 0.57	\$ 0.01	\$ 0.58
Weighted average shares outstanding	107,970		107,970	98,799		98,799
Diluted earnings per share data:						
Earnings per share	\$ 0.59	\$ (0.02)	\$ 0.57	\$ 0.56	\$ 0.01	\$ 0.57
Weighted average shares outstanding	113,566		113,566	100,254		100,254

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	Third quarter 2005			Third quarter 2004		
	As	Adjustments	As	As	Adjustments	As
	previously reported		restated	previously reported		restated
Total revenue	\$ 412,031	\$	\$ 412,031	\$ 322,197	\$ 65	\$ 322,262
Net earnings	\$ 7,950	\$ (538)	\$ 7,412	\$ 15,803	\$ (337)	\$ 15,466
Basic earnings per share data:						
Earnings per share	\$ 0.08	\$ (0.01)	\$ 0.07	\$ 0.16	\$	\$ 0.16
Weighted average shares outstanding	105,623		105,623	97,019		97,019
Diluted earnings per share data:						
Earnings per share	\$ 0.07	\$	\$ 0.07	\$ 0.16	\$	\$ 0.16
Weighted average shares outstanding	109,818		109,818	98,409		98,409
	Second quarter 2005			Second quarter 2004		
	As	Adjustments	As	As	Adjustments	As
	previously reported		restated	previously reported		restated
Total revenue	\$ 404,837	\$	\$ 404,837	\$ 317,270	\$ 335	\$ 317,605
Net earnings	\$ 64,058	\$ (702)	\$ 63,356	\$ 46,415	\$ (641)	\$ 45,774
Basic earnings per share data:						
Earnings per share	\$ 0.61	\$ (0.01)	\$ 0.60	\$ 0.48	\$ (0.01)	\$ 0.47
Weighted average shares outstanding	104,962		104,962	96,807		96,807
Diluted earnings per share data:						
Earnings per share	\$ 0.59	\$	\$ 0.59	\$ 0.47	\$ (0.01)	\$ 0.46
Weighted average shares outstanding	108,269		108,269	98,690		98,690

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	First quarter 2005			First quarter 2004		
	As	Adjustments	As	As	Adjustments	As
	previously reported		restated	previously reported		restated
Total revenue	\$ 379,678	\$ (1,453)	\$ 378,225	\$ 278,018	\$ (335)	\$ 277,683
Net earnings	\$ 57,318	\$ (1,930)	\$ 55,388	\$ 44,568	\$ (427)	\$ 44,141
Basic earnings per share data:						
Earnings per share	\$ 0.56	\$ (0.02)	\$ 0.54	\$ 0.46		\$ 0.46
Weighted average shares outstanding	103,241		103,241	96,374		96,374
Diluted earnings per share data:						
Earnings per share	\$ 0.54	\$ (0.02)	\$ 0.52	\$ 0.45		\$ 0.45
Weighted average shares outstanding	105,734		105,734	98,126		98,126

During the fourth and third quarters of 2005, losses from the 2005 hurricanes reduced net earnings \$9.9 million and \$48.3 million, respectively. Also in the third quarter of 2005, we recorded a \$16.9 million after-tax loss due to a commutation. During the third quarter of 2004, losses from the 2004 hurricanes decreased net earnings \$35.7 million. During the fourth quarter of 2004, we reduced the hurricane reserves by \$14.2 million after-tax based on our assessment of new and additional claim information, and also strengthened our reserves for discontinued lines by a similar amount.

The sum of earnings per share for the quarters may not equal the annual amounts due to rounding.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

(18) SUBSEQUENT EVENTS

Based on the Special Committee's voluntary independent investigation of our past practices related to granting stock options, we determined that the price on the actual measurement date for a number of our stock option grants during the period 1997 through 2005 and into 2006 did not correspond to the price on the stated grant date and that certain option grants were retroactively repriced. The investigation was conducted with the help of a law firm that was not previously involved with our stock option plans and procedures. The SEC has commenced an informal inquiry. In connection with its inquiry, we received a document request from the SEC. We intend to fully cooperate with the informal inquiry. We are unable to predict the outcome of or the future costs related to the informal inquiry.

On October 30, 2006, we received a registered letter from U.S. Bank, as trustee for the holders of our 2.00% Convertible Notes due 2021, 1.30% Convertible Notes due 2023 and 2.00% Convertible Exchange Notes due 2021, stating that U.S. Bank, as trustee, had not received our consolidated financial statements for the quarter ended June 30, 2006. If we do not file our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 with the SEC and deliver the report to the trustee within sixty days from the date notice was received from the trustee, such failure to file and deliver will be considered an Event of Default under the indenture governing the notes. If an Event of Default were to occur under the indentures for any series of the notes, the trustee or holders of at least 25% of the aggregate principal of such series then outstanding could declare all the unpaid principal on such series of notes then outstanding to be immediately due and payable. Likewise, we have not timely delivered our Form 10-Q's for the quarters ended June 30 and September 30, 2006 as required by the terms of our Revolving Loan Facility. The banks that are a party to the agreement waived certain Defaults or Events of Default until January 31, 2007. In addition, our restatement of our prior year financial statements might be considered an Event of Default, which has been waived until January 31, 2007 under our Revolving Loan Facility. Our failure to comply with the covenants in the indentures for our convertible notes and our Revolving Loan Facility in the future could have a material adverse effect on our stock price, business and financial condition if we would not have available funds at that time to repay any defaulted debt. A default and acceleration under the indentures for our convertible notes and loan agreement may also trigger cross-acceleration under our other debt instruments.

In December 2006, our existing Revolving Loan Facility was increased by \$100.0 million to \$300.0 million. Pursuant to the terms of the agreement, the Company can borrow up to \$25 million in addition to what is currently borrowed for working capital purposes. However, the full unfunded amount of the facility would be available to pay any potential convertible note conversion or put.

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HCC Insurance Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(continued, tables in thousands, except per share data)

In April 2006, we were named as a defendant in a complaint related to insurance marketing and producer compensation practices. The lawsuit was filed in Federal District Court in Georgia by a number of corporate plaintiffs against approximately 100 insurance entity defendants. The suit has been transferred to the multi-district litigation proceeding pending in the United States District Court for the District of New Jersey for coordinated or consolidated pre-trial proceedings with suits previously transferred that appear to the court to involve common questions of fact. The complaint alleges violations of Federal antitrust law, the Racketeering Influence and Corrupt Organization Act and various state anti-fraud laws. The lawsuit seeks unspecified damages. We are vigorously contesting this action.

The Financial Accounting Standards Board (FASB) has issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*. Effective January 1, 2007, FIN 48 clarifies the accounting for uncertain income tax positions. We are currently reviewing the requirements of FIN 48 to determine the effect it will have on our consolidated financial statements.

The FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which clarified the definition of fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 will be effective for us on January 1, 2008. We are currently assessing whether the adoption of SFAS 157 will have an impact on our consolidated financial statements.

The Securities and Exchange Commission has issued Staff Accounting Bulletin (SAB) No.108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 establishes a standard approach for quantifying the materiality of errors to current and prior period financial statements. SAB 108's guidelines must be applied in the fourth quarter, and adjustments, if any, will be recorded either by restating prior year financial statements or recording a cumulative effect adjustment as of January 1, 2006. We believe the requirements of SAB 108 will have no effect on our consolidated financial statements.

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HCC INSURANCE HOLDINGS, INC.
SUMMARY OF INVESTMENTS
OTHER THAN INVESTMENTS IN RELATED PARTIES
(in thousands)

		December 31, 2005			
Column A		Column B		Column C	Column D
Type of investment		Cost		Value	Amount at which shown in the balance sheet
Fixed maturities:					
Bonds	United States government and government agencies and authorities	\$	90,404	\$	89,724
Bonds	states, municipalities and political subdivisions		418,179		418,873
Bonds	special revenue		720,320		723,101
Bonds	corporate		381,917		375,582
Asset-backed and mortgage-backed securities			361,456		355,372
Bonds	foreign		304,863		305,972
Total fixed maturities			2,277,139		2,268,624
Equity securities:					
Common stocks	banks, trusts and insurance companies		28,766	\$	36,926
Common stocks	industrial, miscellaneous and all other		40,764		36,095
Non-redeemable preferred stocks			1,033		1,013
Total equity securities			70,563	\$	74,034
Short-term investments			839,581		839,581
Other investments			74,334		75,189
Total investments			\$ 3,261,617		\$ 3,257,428

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HCC INSURANCE HOLDINGS, INC.
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
BALANCE SHEETS
(in thousands)

	December 31,	
	2005	2004
	(As restated)	(As restated)
ASSETS		
Fixed income securities, at fair value (amortized cost: 2005 \$31,023; 2004 \$33,749)	\$ 30,622	\$ 33,716
Cash	3,610	2,242
Short-term investments	38,182	31,006
Investment in subsidiaries	1,790,774	1,391,415
Intercompany loans to subsidiaries for acquisitions	184,706	194,919
Receivable from subsidiaries	37,364	39,997
Other assets	14,056	11,867
Total assets	\$ 2,099,314	\$ 1,705,162
LIABILITIES AND SHAREHOLDERS' EQUITY		
Payable to subsidiaries	\$ 85,821	\$ 55,151
Notes payable	297,400	297,442
Deferred Federal income tax	13,548	6,468
Accounts payable and accrued liabilities	12,110	20,603
Total liabilities	408,879	379,664
Total shareholders' equity	1,690,435	1,325,498
Total liabilities and shareholders' equity	\$ 2,099,314	\$ 1,705,162

See Notes to Condensed Financial Information.

Table of Contents**SCHEDULE 2**

HCC INSURANCE HOLDINGS, INC.
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENTS OF EARNINGS
(in thousands)

	Years ended December 31,		
	2005	2004	2003
	(As	(As	(As
	restated)	restated)	restated)
Equity in earnings of subsidiaries	\$ 188,202	\$ 165,712	\$ 141,319
Interest income from subsidiaries	6,799	6,531	6,827
Net investment income	2,082	994	953
Other operating income	525		2,481
Total revenue	197,608	173,237	151,580
Interest expense	6,552	6,733	6,296
Other operating expense	3,404	2,858	1,781
Total expense	9,956	9,591	8,077
Earnings before income tax expense	187,652	163,646	143,503
Income tax expense (benefit)	(3,540)	947	1,476
Net earnings	\$ 191,192	\$ 162,699	\$ 142,027

See Notes to Condensed Financial Information.

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HCC INSURANCE HOLDINGS, INC.
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)

	Years ended December 31,		
	2005	2004	2003
	(As	(As	(As
	restated)	restated)	restated)
Net earnings	\$ 191,192	\$ 162,699	\$ 142,027
Other comprehensive income (loss):			
Investment gains (losses):			
Gains (losses) during the year, net of income tax charge (benefit) of \$(129) in 2005 and \$12 in 2004	(239)	21	
Consolidated subsidiaries' investment gains (losses) during the year, net of income tax charge (benefit) of \$(2,817) in 2005, \$6,079 in 2004 and \$(1,048) in 2003	(4,018)	10,934	(1,962)
Less consolidated subsidiaries' reclassification adjustment for gains included in net earnings, net of income tax charge of \$2,479 in 2005, \$2,433 in 2004 and \$184 in 2003	(4,605)	(4,518)	(343)
Foreign currency translation adjustment	(9,699)	6,287	6,451
Other comprehensive income (loss)	(18,561)	12,724	4,146
Comprehensive income	\$ 172,631	\$ 175,423	\$ 146,173

See Notes to Condensed Financial Information.

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HCC INSURANCE HOLDINGS, INC.
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENTS OF CASH FLOWS
(in thousands)

	Years ended December 31,		
	2005	2004	2003
	(As	(As	(As
	restated)	restated)	restated)
Cash flows from operating activities:			
Net earnings	\$ 191,192	\$ 162,699	\$ 142,027
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Undistributed net income of subsidiaries	(116,122)	(133,916)	(119,419)
Change in accrued interest receivable added to intercompany loan balances	(6,712)	(6,544)	(6,317)
Change in accounts payable and accrued liabilities	(10,999)	(660)	10,022
Tax benefit from exercise of stock options	6,168	2,969	1,811
Other, net	(4,754)	4,680	3,331
Cash provided by operating activities	58,773	29,228	31,455
Cash flows from investing activities:			
Cash contributions to subsidiaries	(162,872)	(107,000)	(51,364)
Payments for purchase of subsidiaries, net of cash received	(98,829)	(48,975)	(11,624)
Change in short-term investments	(7,176)	29,817	(55,986)
Sales and maturities of fixed income securities	6,200		
Cost of securities acquired	(3,400)	(33,679)	
Change in receivable/payable from subsidiaries	33,303	43,295	(14,008)
Intercompany loans to subsidiaries for acquisitions	(39,685)	(62,523)	(26,838)
Payments on intercompany loans to subsidiaries	56,610	54,694	54,674
Cash used by investing activities	(215,849)	(124,371)	(105,146)
Cash flows from financing activities:			
Proceeds from note payable, net of costs	36,000	29,000	178,000
Payments on notes payable	(36,015)	(29,009)	(107,003)
Sale of common stock, net of costs	186,103	116,776	20,279
Dividends paid	(27,644)	(19,984)	(17,039)
Cash provided by financing activities	158,444	96,783	74,237
Net increase in cash	1,368	1,640	546
Cash at beginning of year	2,242	602	56

Cash at end of year	\$	3,610	\$	2,242	\$	602
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See Notes to Condensed Financial Information.

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**HCC INSURANCE HOLDINGS, INC.
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
NOTES TO CONDENSED FINANCIAL INFORMATION**

- (1) The accompanying condensed financial information should be read in conjunction with the consolidated financial statements and the related notes thereto of HCC Insurance Holdings, Inc. and Subsidiaries. Investments in subsidiaries are accounted for using the equity method. Certain amounts in the 2004 and 2003 condensed financial information have been reclassified to conform with the 2005 presentation. Such reclassifications had no effect on shareholders' equity, net earnings or cash flows.

The restatement adjustments discussed in Note 2 in the consolidated financial statements related to mis-priced options were recorded at a subsidiary of HCC Insurance Holdings. Accordingly, these entries are reflected in the condensed financial information as adjustments to equity in earnings of subsidiaries on the condensed income statement and investment in subsidiaries on the condensed balance sheet. The condensed financial information also reflects other minor adjustments that were made as part of the restatement.

- (2) Intercompany loans to subsidiaries are demand notes issued primarily to fund the cash portion of acquisitions. They bear interest at a rate set by management, which approximates the interest rate charged for similar debt. At December 31, 2005, the interest rate on intercompany loans was 6.0%.
- (3) Other income for 2003 includes a one-time foreign currency transaction gain of \$1.3 million in settlement of an advance to an unaffiliated entity and income from a strategic investment.

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Table of Contents**SCHEDULE 3**

HCC INSURANCE HOLDINGS, INC.
SUPPLEMENTARY INSURANCE INFORMATION
(in thousands)

Column A	Column B	Column C (1)	Column D (1)	Column F	Column G (2)	Column H	Column I	Column J (3)	Column K
	Deferred policy acquisition costs (As restated)	December 31, Future policy benefits, losses, claims and loss expenses (As restated)	Unearned premiums	Premium revenue	Net investment income	Years ended Benefits, claims, losses and settlement expenses (As restated)	Amortization of deferred policy acquisition costs (As restated)	Other operating expenses (As restated)	Premium written
Insurance Company	\$ 88,367	\$ 2,887,135	\$ 807,109	\$ 1,369,988	\$ 88,397	\$ 919,697	\$ 261,708	\$ 84,838	\$ 1,501,224
Agency					7,437			84,107	
Other									
Operations					794			1,732	
Corporate					2,223			10,313	
Total	\$ 88,367	\$ 2,887,135	\$ 807,109	\$ 1,369,988	\$ 98,851	\$ 919,697	\$ 261,708	\$ 180,990	\$ 1,501,224
2004									
Insurance Company	\$ 45,719	\$ 2,163,826	\$ 741,706	\$ 1,010,692	\$ 59,073	\$ 645,230	\$ 222,323	\$ 67,138	\$ 1,105,519
Agency					3,559			91,617	
Other									
Operations					1,236			1,416	
Corporate					1,017			7,874	
Total	\$ 45,719	\$ 2,163,826	\$ 741,706	\$ 1,010,692	\$ 64,885	\$ 645,230	\$ 222,323	\$ 168,045	\$ 1,105,519
2003									
Insurance Company	\$ 18,814	\$ 1,602,861	\$ 592,311	\$ 738,272	\$ 42,345	\$ 488,000	\$ 137,212	\$ 55,814	\$ 865,502
Agency					3,796			75,691	
Other									
Operations					224			2,242	

Table of Contents**SCHEDULE 4**

HCC INSURANCE HOLDINGS, INC.
REINSURANCE
(in thousands)

Column A	Column B	Column C	Column D	Column E	Column F
	Primary amount	Ceded to other companies	Assumed from other companies	Net amount	Percent of amount assumed to net
Year ended December 31, 2005					
Life insurance in force	\$ 1,359,529	\$ 404,228	\$	\$ 955,301	%
Earned premium:					
Property and liability insurance	\$ 1,116,713	\$ 546,275	\$ 266,651	\$ 837,089	32%
Accident and health insurance	577,733	71,127	26,293	532,899	5%
Total	\$ 1,694,446	\$ 617,402	\$ 292,944	\$ 1,369,988	21%
Year ended December 31, 2004					
Life insurance in force	\$ 1,498,559	\$ 435,808	\$	\$ 1,062,751	%
Earned premium:					
Property and liability insurance	\$ 968,444	\$ 615,780	\$ 274,124	\$ 626,788	44%
Accident and health insurance	589,362	233,830	28,372	383,904	7%
Total	\$ 1,557,806	\$ 849,610	\$ 302,496	\$ 1,010,692	30%
Year ended December 31, 2003					
Life insurance in force	\$ 1,443,611	\$ 481,870	\$	\$ 961,741	%

Earned premium:

Property and liability insurance	\$	651,893	\$	454,294	\$	205,165	\$	402,764	51%
Accident and health insurance		537,463		294,505		92,550		335,508	28%
Total	\$	1,189,356	\$	748,799	\$	297,715	\$	738,272	40%

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HCC INSURANCE HOLDINGS, INC.
VALUATION AND QUALIFYING ACCOUNTS
(in thousands)

	2005	2004	2003
Reserve for uncollectible reinsurance:			
Balance at beginning of year	\$ 20,425	\$ 14,991	\$ 7,142
Provision charged to expense	5,750	6,616	7,671
Reclassification to indemnification liability	(9,000)		
Amounts (written off) recovered	(5,034)	(1,182)	178
Balance at end of year	\$ 12,141	\$ 20,425	\$ 14,991
Allowance for doubtful accounts:			
Balance at beginning of year	\$ 4,911	\$ 2,549	\$ 2,279
Acquisition of subsidiaries		1,931	13
Provision charged to expense	1,917	546	167
Amounts (written off) recovered and other	566	(115)	90
Balance at end of year	\$ 7,394	\$ 4,911	\$ 2,549

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INDEX TO EXHIBITS

(Items denoted by a letter are incorporated by reference to other documents previously filed with the Securities and Exchange Commission as set forth at the end of this index. Items not denoted by a letter are being filed herewith.)

Exhibit

Number

- ^A3.1 -Restated Certificate of Incorporation and Amendment of Certificate of Incorporation of HCC Insurance Holdings, Inc., filed with the Delaware Secretary of State on July 23, 1996 and May 21, 1998, respectively.
 - ^B3.2 -Bylaws of HCC Insurance Holdings, Inc., as amended.
 - ^B4.1 -Specimen of Common Stock Certificate, \$1.00 par value, of HCC Insurance Holdings, Inc.
 - ^C4.2 -Indenture dated August 23, 2001 between HCC Insurance Holdings, Inc. and First Union National Bank related to Debt Securities (Senior Debt).
 - ^C4.3 -First Supplemental Indenture dated August 23, 2001 between HCC Insurance Holdings, Inc. and First Union National Bank related to 2.00% Convertible Notes Due 2021.
 - ^D4.4 -Second Supplemental Indenture dated March 28, 2003 between HCC Insurance Holdings, Inc. and Wachovia Bank, National Association (as successor to First Union National Bank) related to 1.30% Convertible Notes Due 2023.
 - ^E4.5 -First Amendment to Second Supplemental Indenture dated December 22, 2004 between HCC Insurance Holdings, Inc. and Wachovia Bank, National Association related to 1.30% Convertible Notes Due 2023.
 - ^F4.6 -Third Supplemental Indenture dated November 23, 2004 between HCC Insurance Holdings, Inc. and Wachovia Bank, National Association related to 2.00% Convertible Notes Due 2021.
 - ^G10.1 -Loan Agreement (\$200,000,000 Revolving Loan Facility) dated at November 24, 2004 among HCC Insurance Holdings, Inc.; Wells Fargo Bank, National Association; Southwest Bank of Texas, N.A.; Citibank, N.A.; Royal Bank of Scotland and Bank of New York.
 - ^H10.2 -HCC Insurance Holdings, Inc. 1995 Flexible Incentive Plan, as amended and restated.
 - ^H10.3 -HCC Insurance Holdings, Inc. 1997 Flexible Incentive Plan, as amended and restated.
 - ^H10.4 -HCC Insurance Holdings, Inc. 1996 Nonemployee Director Stock Option Plan, as amended and restated.
 - ^I10.5 -HCC Insurance Holdings, Inc. 2001 Flexible Incentive Plan, as amended and restated.
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Exhibit
Number

J10.6	-Form of Incentive Stock Option Agreement under the HCC Insurance Holdings, Inc. 2001 Flexible Incentive Plan.
K10.7	-HCC Insurance Holdings, Inc. 2004 Flexible Incentive Plan.
F10.8	-Form of Incentive Stock Option Agreement under the HCC Insurance Holdings, Inc. 2004 Incentive Plan.
F10.9	-Amended and Restated Employment Agreement effective at November 10, 2004, between HCC Insurance Holdings, Inc. and Stephen L. Way.
L10.10	-HCC Insurance Holdings, Inc. nonqualified deferred compensation plan for Stephen L. Way effective January 1, 2003.
M10.11	-Employment Agreement effective at March 1, 2005, between HCC Insurance Holdings, Inc. and Craig J. Kelbel.
J10.12	-Employment Agreement effective at June 3, 2002, between HCC Insurance Holdings, Inc. and Michael J. Schell.
N10.13	-Employment Agreement effective at January 1, 2002, between HCC Insurance Holdings, Inc. and Edward H. Ellis, Jr.
P10.14	-Consulting Agreement and Resignation effective as of November 17, 2006 by and between HCC Insurance Holdings, Inc. and Stephen L. Way.
Q10.15	-Separation Agreement and Release effective as of November 17, 2006 by and between HCC Insurance Holdings, Inc. and Christopher L. Martin.
12	-Statement Regarding Computation of Ratios.
O 14	-Form of HCC Insurance Holdings, Inc. Code of Ethics Statement by Chief Executive Officer and Senior Financial Officers.
O 21	-Subsidiaries of HCC Insurance Holdings, Inc.
24	-Powers of Attorney.
31.1	-Certification by Chief Executive Officer.
31.2	-Certification by Chief Financial Officer.
32.1	-Certification with respect to Annual Report of HCC Insurance Holdings, Inc.

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- A Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Registration
Statement on
Form S-8
(Registration
No. 333-61687)
filed August 17,
1998.
- B Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Registration
Statement on
Form S-1
(Registration
No. 33-48737)
filed
October 27,
1992.
- C Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 8-K dated
August 19,
2001.
- D Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 8-K dated
March 25, 2003.
- E Incorporated by
reference to the
Exhibits to HCC
Insurance

Holdings, Inc. s
Form 8-K dated
December 22,
2004.

F Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 10-K for
the year ended
December 31,
2004.

G Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 8-K filed
December 1,
2004.

H Incorporated by
reference to
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 10-K for
the year ended
December 31,
1999.

I Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Definitive Proxy
Statement for
the May 22,
2002 Annual
Meeting of
Shareholders
filed April 26,
2002.

J Incorporated by
reference to the
Exhibits to HCC

Insurance
Holdings, Inc. s
Form 10-K for
the year ended
December 31,
2002.

K Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Definitive Proxy
Statement for
the May 13,
2004 Annual
Meeting of
Shareholders
filed April 16,
2004.

L Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 10-K for
the year ended
December 31,
2003.

M Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 10-Q for
the quarter
ended
March 31, 2005.

N Incorporated by
reference to the
Exhibits to HCC
Insurance
Holdings, Inc. s
Form 10-K for
the year ended
December 31,
2001.

- O Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-K for the year ended December 31, 2005.
- P Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated November 17, 2006.
- Q Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated November 28, 2006.