HCC INSURANCE HOLDINGS INC/DE/
Form 10-K
February 29, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**
For the fiscal year ended December 31, 2011

Commission file number 001-13790

HCC Insurance Holdings, Inc.

(Exact name of registrant as specified in its charter)

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

(713) 690-7300

(Registrant s telephone number, including area code)

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

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). þ Yes ¨ No

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No þ

The aggregate market value on June 30, 2011 (the last business day of the registrant s most recently completed second fiscal quarter) of the voting stock held by non-affiliates of the registrant was approximately $3.4 billion. For purposes of the determination of the above-stated amount, only Directors and executive officers are presumed to be affiliates, but neither the registrant nor any such person concede that they are affiliates of the registrant.

The number of shares outstanding of the registrant s Common Stock, $1.00 par value, at February 17, 2012 was 104.0 million.

DOCUMENTS INCORPORATED BY REFERENCE:

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

HCC INSURANCE HOLDINGS, INC.

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. These forward-looking statements reflect our current expectations and projections about future events and include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this Report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as growth of our business and operations, business strategy, competitive strengths, goals, plans, future capital expenditures and references to future successes may be considered forward-looking statements. Generally, words such as anticipate, believe, estimate, expect, intend, plan, p or similar expressions indicate forward-looking statements.

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

the effects of catastrophic losses,

the cyclical nature of the insurance business,

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

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

the effects of emerging claim and coverage issues,

the effects of extensive governmental regulation of the insurance industry,

changes to the country s health care delivery system,

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

potential credit risk with brokers,

the effects of industry consolidations,

our assessment of underwriting risk,

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

the adequacy of reinsurance protection, *the ability and willingness of reinsurers to pay balances due us,*

the occurrence of terrorist activities,

our ability to maintain our competitive position,

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

changes in our assigned financial strength ratings,

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

attraction and retention of qualified employees, *our ability to successfully expand our business through the acquisition of insurance-related companies,*

impairment of goodwill,

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

fluctuations in foreign exchange rates,

failures or constraints of our information technology systems,

difficulties with outsourcing relationships, and

change of control.

We describe these risks and uncertainties in greater detail in Item 1A, Risk Factors.

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

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

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

PART I

Item 1. ***Business***

Business Overview

HCC Insurance Holdings, Inc. is a leading specialty insurer with offices in the United States, the United Kingdom, Spain and Ireland. We underwrite a variety of relatively non-correlated specialty insurance products, including property and casualty, accident and health, surety, credit and aviation product lines, in approximately 180 countries. We market our products through a network of independent agents and brokers, producers, managing general agents and directly to consumers. Our businesses are managed through five underwriting segments and our Investing segment. Our underwriting segments are U.S. Property & Casualty, Professional Liability, Accident & Health, U.S. Surety & Credit and International. Our principal executive offices are located in Houston, Texas.

Since our founding in 1974, we have been consistently profitable while successfully growing our premium and shareholders equity. During the five-year period from 2007 2011, our gross written premium increased 8% from $2.5 billion to $2.6 billion, while net written premium increased 10% from $2.0 billion to $2.2 billion. Since December 31, 2007, our shareholders equity has increased 35% from $2.4 billion to $3.3 billion and our assets have increased 19% from $8.1 billion to $9.6 billion. Driving the increases in shareholders equity are our profitable underwriting results, as indicated by our average combined ratio of 85.6% for the period 2007 2011.

The diversity of our insurance offerings and our consistent underwriting performance have allowed us to maintain financial strength ratings of AA (Very Strong) from Standard & Poor s Corporation (3rd of 21 ratings), A+ (Superior) from A.M. Best Company, Inc. (2nd of 16 ratings), AA (Very Strong) from Fitch Ratings (3rd of 19 ratings), and A1 (Good Security) by Moody s Investors Service, Inc. (5th of 21 ratings) for our major domestic and international insurance companies. These ratings are among the highest within the property and casualty insurance industry, and we believe they provide a competitive advantage in many of our chosen lines of business.

Our Strategy

Our business philosophy is to maximize underwriting profit while managing risk. We concentrate our insurance writings in selected specialty lines of business in which we believe we can achieve meaningful underwriting profit. We also rely on our experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to limit or reduce risk. Our business plan is shaped by our underlying business philosophy. As a result, our primary objective is to maximize net earnings and grow book value per share, rather than to grow gross written premium or our market share.

Key elements of our strategy are further discussed below:

Non-correlated Specialty Lines of Business

We offer over 100 classes of specialty insurance through offices in the United States, the United Kingdom, Ireland and Spain. The diversity of our product lines provides operational flexibility, which permits us to shift the focus of our insurance underwriting activity among our various lines of business. Shifting our underwriting activity allows us to emphasize more profitable lines of business during periods of increased premium rates and de-emphasize less profitable lines during periods of increased competition. We can accomplish these shifts by increasing or decreasing the amount of gross premium written or by adjusting the amount of business reinsured.

While the cycles are different for many of our lines of business, most of them remain competitive. However, our underwriting activities remain profitable. During the past several years, we expanded our underwriting activities and increased our retention in lines of business with favorable expected profitability. We were able to accomplish this due to the increased diversification provided by our overall book of business and due to our increased capital strength. These higher retention levels increased our net written and earned premium, and we believe will result in additional underwriting profit, investment income, net earnings and growth in book value.

Underwriting and Pricing

Integral to our strategy is attracting and retaining professionals with the requisite skill and knowledge to underwrite our diverse specialty product lines. These professionals include industry-leading experts in our chosen specialty lines with the authority to make decisions and quickly respond to our clients and brokers unique and rapidly changing needs.

Although our underwriters focus deeply on different classes of specialty insurance, our culture and compensation practices promote disciplined underwriting and the generation of underwriting profit above all other measures. Pricing for each product is based on various factors, including premium rates, the availability and cost of reinsurance, policy terms and conditions, and market conditions. Core to our overall underwriting performance is the maintenance of an expense ratio that is substantially lower than our peers. We accomplish this through disciplined expense management and a streamlined management structure.

Reinsurance

We purchase reinsurance to limit our net losses from both individual and catastrophic risks. Through reinsurance, we may transfer or cede all or part of the risk we have underwritten to a reinsurance company in exchange for all of part of the premium we received to write the policy. The amount of reinsurance we purchase varies depending on the particular risks inherent in the policies underwritten; the pricing, coverage and terms of the reinsurance; and the competitive conditions within the relevant lines of business.

When we decide to retain more underwriting risk in a particular line of business, we do so with the intention of retaining a greater portion of any underwriting profit. In this regard, we may purchase less proportional or quota share reinsurance, thus accepting more of the risk. However, we may purchase specific excess of loss reinsurance, in which we transfer to reinsurers both premium and losses on a non-proportional basis for individual and catastrophic occurrence risks above a retention point. Additionally, we may obtain facultative reinsurance protection on individual risks. In some cases, we may choose not to purchase reinsurance in a line of business where there has been favorable loss history or our policy limits are relatively low ($5.0 million or lower) and we determine there is a low likelihood of catastrophe exposure.

Acquisitions

We have historically accomplished significant growth through the successful acquisition and integration of insurance companies and underwriting agencies, making over 40 acquisitions since becoming a public company in 1974. In recent years, we have also actively recruited and hired new underwriting teams that we believe present opportunities for future profits and expansion of our business. In considering potential acquisitions, we remain disciplined in pursuing those businesses that meet our requirements for return on investment and cultural fit. We expect to continue to acquire complementary businesses and underwriting teams. We believe we can enhance acquired businesses and platforms for new underwriting teams with our infrastructure, ratings and financial strength.

Investments

Our primary objective with respect to our investment portfolio is to preserve and grow HCC s shareholders equity through disciplined investment selection and diversification. We invest substantially all of our available funds in highly-rated fixed income securities, the majority of which are designated as available for sale securities. Our investment strategy is to maximize investment income and yield within our risk tolerance, rather than to maximize total return.

Segment and Geographic Information

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

Insurance Underwriting Operations

Our insurance operations are managed within our insurance underwriting segments, each of which reports to an HCC executive who is responsible for the segment results. The following provides an overview of each of these segments.

U.S. Property & Casualty Segment

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

Since December 2010, we have added three underwriting teams focused separately on technical property, primary casualty and excess casualty coverages. These new teams collectively generated gross written premium of $16.7 million during 2011. We believe these new specialty lines are well-positioned for profitability and growth as market conditions improve.

Key lines of business within this segment are further described below:

Aviation

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

E&O

Our E&O business consists of policies with low limits ($5.0 million or less). We provide E&O coverage to more than 100 classes of professional service providers, of which architects, engineers and related construction practices represent the largest concentration of insured professionals. Our managing general agencies have provided insurance and risk management services for more than twenty years to these classes. We do not write a material amount of E&O coverage for the legal, medical or accounting professions. Our E&O business is produced through both wholesale and specialty retail brokers and is underwritten on both an admitted and surplus lines basis.

Public Risk

We are a recognized leader in public risk insurance, expanding our business through acquisitions and organic growth. We provide insurance coverage and associated risk management services to municipal entities and special districts, mainly serving populations of less than 50,000 in the United States.

Contingency and Disability

As a leader in the contingency market, we provide weather insurance and event cancellation, covering events such as collegiate championships, All-Star Games and large musical concerts. We write large limits (greater than $10.0 million) and purchase significant proportional and excess of loss reinsurance to manage our contingency exposures. We also write kidnap & ransom insurance, providing coverage throughout the world. In addition, we are a leading underwriter of specialty disability products, providing coverage of irreplaceable human assets, such as high profile athletes, entertainers and business executives.

Professional Liability Segment

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

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

Accident & Health Segment

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

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

Key lines of business within this segment are further described below:

Medical Stop-Loss

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

HMO Reinsurance

HMO reinsurance is coverage for high severity claims incurred by Health Maintenance Organizations (HMO). There are over 400 licensed HMOs in the United States, and HMO reinsurance is distributed through a network of consultants and brokers working directly with these organizations. Through our long history of underwriting the HMO market, we have expertise that allows us to underwrite each risk based on its own merits.

Short-term Medical

International travel accident coverage provides health insurance to travelers while outside the jurisdiction of their primary medical insurance coverage. This coverage includes highly-specialized services designed to accommodate the unique needs of the international traveler. The products are purchased through an Internet portal accessed by brokers, consultants and individuals. In addition, we offer specially-designed products for foreign nationals seeking citizenship in the United States and American expatriates stationed around the world. We have customized systems and the experience to handle the complexities of worldwide health insurance.

U.S. Surety & Credit Segment

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

Surety

Our surety business includes contract surety bonds, commercial surety bonds and bail bonds. A large amount of our contract surety book is characterized by relatively small limits and premiums. Significant classes within commercial surety are license and permit bonds, court bonds for fiduciaries as well as appeal bonds, and plug and abandonment bonds. Most of our commercial surety bond business is also small limit and small premium business, but we also have a modest but growing

Large Commercial Surety business. Our surety business is typically received from a large number of independent agents specializing in these coverages or from specialized units of large brokerage companies.

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

Credit

The credit insurance business provides insurance policies insuring payment for export trade transactions, as well as structured trade transactions. Political risk insurance is also provided, as well as insurance for letters of credit being honored. The business is large limit and large premium business. Underwriting includes credit quality analysis of individual transactions, as well as controlling aggregation of limits by debtor and by country. Potential claims are reported promptly. Claim payments are generally made in a short time horizon, but subrogation recoveries frequently take an extended amount of time, resulting in the business having a medium tail.

International Segment

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

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

Key lines of business within this segment are further described below:

Energy

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

Property Treaty

In late 2009, we acquired a new underwriting team that provides reinsurance to a variety of clients around the world, offering coverage on a range of products including property catastrophe treaty, property risk and engineering treaty, and property terrorism treaty in the U.S. and internationally. Catastrophe excess of loss business is the largest portion of the portfolio, with a focus on high level layers. The business is characterized by large limits, large premiums and short to medium-tail claims reporting and settlement.

Liability

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

Surety & Credit

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

Property (Direct and Facultative)

We write direct and facultative all risks property coverage, often with catastrophe exposure, for numerous classes including manufacturing, retail, real estate, hotels and municipalities, with a focus on excess of loss attachment. We provide coverage for both physical damage and business interruption on a worldwide basis to companies ranging in size from small to multinational. We also write all risks insurance for major ocean-going vessels, as well as port authority and marine properties around the world.

Investment Operations

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

Our investment objectives are as follows:

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

For additional discussion about the composition and results of our Investing Segment, see Investing Segment included in Management s Discussion and Analysis.

Corporate & Other

Our Corporate & Other category includes operations not related to our segments, including unallocable corporate operating expenses, consolidated interest expense and underwriting results of our Exited Lines of business. Our Exited Lines include these six product lines that we no longer write and do not expect to write in the future: 1) accident and health business managed by our underwriting agency, LDG Reinsurance, 2) workers compensation, 3) provider excess, 4) Spanish medical malpractice, 5) U.K. motor and 6) film completion bonds.

Enterprise Risk Management

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

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

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

Reserves for Insurance Claims

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

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

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

The table on the following page shows development of our reserves from 2001 through 2011, as of December 31, 2011. The first line shows our net reserves, including reserves for IBNR, recorded on our balance sheet at the indicated year end. The first section of the table shows, by year, the cumulative amount of net losses and loss adjustment expenses paid at the end of each succeeding year. The second section shows the re-estimated net reserves in later years for the years indicated. The cumulative redundancy (deficiency) line represents the difference between the latest re-estimated net reserves and the originally estimated net reserves. The bottom section of the table shows our gross reserves and reinsurance recoverables, as well as their re-estimated amounts at the indicated year end.

housands)	**2011**	**2010**	**2009**	**2008**	**2007**	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**
rves, net insurance	$2,683,483	$2,537,772	$2,555,840	$2,416,271	$2,342,800	$2,108,961	$1,533,433	$1,059,283	$705,200	$458,702	$313,(
rve stments*	-	6,261	14,371	31,704	59,301	48,599	26,508	6,327	-	5,587	
sted ves, net of urance	2,683,483	2,544,033	2,570,211	2,447,975	2,402,101	2,157,560	1,559,941	1,065,610	705,200	464,289	313,(
ulative net of urance, at:											
year later		726,445	763,140	618,699	687,675	556,096	222,336	172,224	141,677	115,669	126,(
years later			1,144,929	1,001,369	940,636	858,586	420,816	195,663	135,623	152,674	131,2
e years				1,263,091	1,177,900	1,013,122	588,659	337,330	124,522	115,214	163,8
years later					1,331,379	1,176,404	702,072	424,308	217,827	88,998	93,4
years later						1,299,663	822,133	495,642	313,315	155,708	59,9
ears later							927,657	581,418	376,903	242,904	125,3
n years								661,517	442,736	301,828	186,2
t years									498,399	351,404	236,2
years later										378,363	270,4
years later											293,(
stimated lity, net of urance, at:											
of year	2,683,483	2,544,033	2,570,211	2,447,975	2,402,101	2,157,560	1,559,941	1,065,610	705,200	464,289	313,(
year later		2,554,180	2,547,548	2,394,451	2,319,730	2,131,163	1,553,415	1,091,004	735,678	487,403	306,3
years later			2,507,068	2,340,380	2,230,481	2,020,736	1,526,922	1,090,282	770,497	500,897	338,1
e years				2,264,611	2,173,281	1,921,345	1,438,838	1,084,299	792,099	571,403	366,8
years later					2,096,935	1,888,984	1,369,333	1,043,492	808,261	585,741	418,7
years later						1,827,814	1,347,280	1,018,785	794,740	613,406	453,5
ears later							1,296,660	1,019,036	792,896	597,666	462,1
n years								983,646	783,442	602,546	455,2
t years									782,921	600,667	452,2
years later										621,719	449,5
years later											467,1
ulative ndancy ciency), of surance		($10,147)	$63,143	$183,364	$305,166	$329,746	$263,281	$81,964	($77,721)	($157,430)	($154,(
s reserves, of year*	$3,658,317	$3,478,210	$3,507,291	$3,448,990	$3,291,269	$3,149,643	$2,842,133	$2,095,903	$1,525,313	$1,164,502	$1,132,2
surance verables*	974,834	934,177	937,080	1,001,015	889,168	992,083	1,282,192	1,030,293	820,113	700,213	819,1
reserves, of year*	$2,683,483	$2,544,033	$2,570,211	$2,447,975	$2,402,101	$2,157,560	$1,559,941	$1,065,610	$705,200	$464,289	$313,(
stimated s reserves	$3,658,317	$3,479,178	$3,424,655	$3,194,269	$2,898,179	$2,656,271	$2,399,055	$1,862,091	$1,582,360	$1,468,342	$1,452,6
stimated urance verables	974,834	924,998	917,587	929,658	801,244	828,457	1,102,395	878,445	799,439	846,623	985,4

stimated eserves	$2,683,483	$2,554,180	$2,507,068	$2,264,611	$2,096,935	$1,827,814	$1,296,660	$983,646	$782,921	$621,719	$467,1
ulative s ndancy ciency)		($968)	$82,636	$254,721	$393,090	$493,372	$443,078	$233,812	($57,047)	($303,840)	($320,3

* Adjusted for acquisitions and dispositions of subsidiaries.

The deficiency for 2010 reflected in the above table resulted directly from our increase in reserves for the diversified financial products line of business in our Professional Liability Segment in 2011. This increase primarily affected the 2010 and 2009 accident years. See the Segment Operations Professional Liability Segment section in Management s Discussion and Analysis for additional discussion.

The redundancies for 2004 through 2009 reflected in the above table were recorded as favorable development in the years shown in the following table (in thousands):

	00000 **Gross**	00000 **Net**
2011 (excluding diversified financial products)	$ 158,797	$ 94,010
2010	16,352	22,663
2009	90,435	53,524
2008	72,044	82,371
2007	90,621	26,397

The majority of this favorable development related to the 2002 2007 underwriting years for these products: 1) D&O in our Professional Liability segment, for the 2002 2006 underwriting years, 2) U.K. professional indemnity, energy and property (including redundancy on the 2005 and 2008 hurricanes) in our International segment, 3) surety in our U.S. Surety & Credit segment and 4) an assumed quota share program in our U.S. Property & Casualty segment.

The deficiencies for 2001 through 2003 reflected in the above table resulted primarily from run-off assumed accident and health reinsurance business in our Exited Lines, recorded in the years shown in the following table (in thousands):

	00000 **Gross**	**00000** **Net**
2006	$ 15,054	$ 25,097
2005	49,775	34,970
2004	127,707	27,326
2003	132,924	28,751

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

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

For additional discussion of our reserve processes and the changes in our loss and loss adjustment expense for 2011, 2010 and 2009, see Critical Accounting Policies Reserves included in Management s Discussion and Analysis.

Regulation

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

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

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

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

Although the U.S. Federal government has not historically regulated the insurance industry, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), enacted in July 2010, expands the federal presence in insurance oversight. The Act s requirements include streamlining the state-based regulation of reinsurance and non-admitted insurance. This Act also establishes a new Federal Insurance Office (FIO) within the U.S. Department of the Treasury with powers over all lines of insurance except health insurance, certain long-term care insurance and crop insurance. The FIO is authorized to, among other things, gather data and information to monitor aspects of the insurance industry, identify issues in the regulation of insurers about insurance matters, and preempt state insurance measures under certain circumstances.

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

HCC Europe is domiciled in Spain and operates as a licensed insurance company in the European Union (EU). HCC Europe s primary regulator is the Spanish General Directorate of Insurance and Pension Funds of the Ministry of the Economy and Treasury (Dirección General de Seguros y Fondos de Pensiones del Ministerio de Economía y Hacienda).

The EU is phasing in a new regulatory regime for the regulation of financial services known as Solvency II , which is built on a risk-based approach to setting capital requirements for insurers and reinsurers. Solvency II aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements. Solvency II is expected to be implemented in 2013, and we will be required to meet its requirements.

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

American Contractors Indemnity Company
Avemco Insurance Company
HCC Europe
HCC International Insurance Company
HCC Life Insurance Company
HCC Reinsurance Company Limited
HCC Specialty Insurance Company
Houston Casualty Company
Houston Casualty Company-London
Lloyd s of London Syndicate 4141
Perico Life Insurance Company
United States Surety Company
U.S. Specialty Insurance Company

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

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

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

Risk-Based Capital

The NAIC has developed a model for analyzing insurance companies called risk-based capital. The risk-based capital model is intended to establish minimum capital thresholds that vary with the size and mix of an insurance company s business and assets. It is designed to identify companies with capital levels that may require regulatory attention. At December 31, 2011, each of our domestic insurance companies total adjusted capital was significantly in excess of the authorized control level risk-based capital.

Insurance Holding Company Acts

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

Terrorism Risk Insurance Act

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

Under the Reauthorization Act, we are required to offer terrorism coverage to our commercial policyholders in certain lines of business, for which we may, when warranted, charge an additional premium. The policyholders may or may not accept such coverage. Our deductible for 2012 is approximately $135.5 million, which we would have to meet before the Federal reimbursement would occur.

Legislative Initiatives

In recent years, state legislatures have considered or enacted laws that modify and, in many cases, increase state authority to regulate insurance companies and insurance holding company systems. State insurance regulators are members of the NAIC, which seeks to promote uniformity of and to enhance the state regulation of insurance. In addition, the NAIC and state insurance regulators, as part of the NAIC s state insurance department accreditation program and in response to new federal laws, have re-examined existing state laws and regulations. Specifically they focused on insurance company investments, issues relating to the solvency of insurance companies, licensing and market conduct issues, streamlining agent licensing and policy form approvals, adoption of privacy rules for handling policyholder information, interpretations of existing laws, the development of new laws and the definition of extraordinary dividends.

In recent years, a variety of measures have been proposed at the U.S. federal level to reform the current process of Federal and state regulation of the financial services industries, which include the banking, insurance and securities industries. These measures, which are often referred to as financial services modernization, have as a principal objective the elimination or modification of regulatory barriers to cross-industry combinations involving banks, securities firms and insurance companies. Also, the U.S. Federal government has recently expanded its presence in insurance oversight, as a result of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Although we believe state regulation of the insurance business would likely continue, an additional layer of federal regulation may arise in the future. In addition, some insurance industry trade groups are actively lobbying for legislation that would allow an option for a separate Federal charter for insurance companies. The full extent to which the Federal government could decide to directly regulate the business of insurance has not been determined by lawmakers.

State regulators in many states have initiated or are participating in industry-wide investigations of sales and marketing practices in the insurance industry. Such investigations have resulted in restitution and settlement payments by some companies and criminal charges against some individuals. The investigations have led to changes in the structure of compensation arrangements, the offering of certain products and increased transparency in the marketing of many insurance products.

We do not know at this time the full extent to which these Federal or state legislative or regulatory initiatives will or may affect our operations and no assurance can be given that they would not, if adopted or modified, have a material adverse effect on our business or our results of operations.

Executive Officers

Name	**Principal occupation during past five years**	**Age**	**Served HCC since**
Barry J. Cook	Mr. Cook has served as our Executive Vice President of International Operations and Chief Executive Officer of HCC Insurance Holdings (International) Limited, with oversight for our international operations, since 2006. From 1992 to 2005, Mr. Cook served as Chief Executive Officer of Rattner Mackenzie Limited, which we acquired in 1999.	51	1999
Brad T. Irick	Mr. Irick has served as our Executive Vice President since May 2010 and our Chief Financial Officer since August 2010. Prior to joining HCC, Mr. Irick was with PricewaterhouseCoopers LLC for 18 years, where he served as audit and advisory partner for several multinational public insurance company clients, including HCC between 2004 and the first half of 2007. Prior to PricewaterhouseCoopers LLC, Mr. Irick was at KPMG LLP. Mr. Irick is a Certified Public Accountant.	45	2010
Craig J. Kelbel	Mr. Kelbel has served as our Executive Vice President of Life, Accident & Health Operations since 2002 and President and Chief Executive Officer of HCC Life Insurance Company since 2005. Prior to joining HCC, Mr. Kelbel was the President of USBenefits Insurance Services, Inc. and Vice President of its parent company, The Centris Group, Inc., which HCC acquired in 1999. Mr. Kelbel has over 35 years of experience in the insurance industry.	57	1999

Name	Principal occupation during past five years	Age	Served HCC since
John N. Molbeck, Jr	Mr. Molbeck has served as our Chief Executive Officer of HCC since May 2009 and as a member of our Board of Directors since 2005. From May 2009 to May 2011, he also served as our President. From 2006 to May 2009, Mr. Molbeck served as President and Chief Operating Officer of HCC, a position he also held from 1997 to 2002. From 2003 through 2005, Mr. Molbeck served as Chief Executive Officer of Jardine Lloyd Thompson LLC, a retail insurance brokerage firm, which was, at the time, a subsidiary of Jardine Lloyd Thompson Group, plc. Prior to initially joining HCC in 1997, Mr. Molbeck had served as the Managing Director of Aon Natural Resources Group, a subsidiary of Aon Corporation. Mr. Molbeck currently serves as a member of the Investment and Finance Committee and the Enterprise Risk Oversight Committee of our Board.	65	2006
Pamela J. Penny	Ms. Penny has served as our Executive Vice President and Chief Accounting Officer since 2008. She previously served as Senior Vice President Finance from 2004 to November 2008. Prior to joining HCC, Ms. Penny served as Senior Vice President and Controller for Aegis Mortgage Corporation from 2003 to 2004 and in varying capacities with American International Group, Inc. (formerly American General Corporation), including Senior Vice President & Controller of American General, from 1991 to 2003. Prior to that time, she was a partner in the international accounting firm KPMG LLP. Ms. Penny is a Certified Public Accountant.	57	2004
Randy D. Rinicella	Mr. Rinicella has served as our Senior Vice President, General Counsel and Secretary since 2007. Prior to joining HCC, Mr. Rinicella was Vice President, General Counsel and Secretary of Dresser-Rand Group, Inc., a publicly-traded equipment supplier to the worldwide oil, gas, petrochemical and process industries, from 2005 until 2007. Mr. Rinicella was a shareholder at the national law firm of Buchanan Ingersoll PC from 2004 until 2005, where he was a member of the firm s corporate finance & technology practice, and a partner in the law firm of Roetzel & Andress from 2002 to 2004.	54	2007
Michael J. Schell	Mr. Schell has served as our Executive Vice President since 2002. In addition, since 2010, Mr. Schell has served as our Chief Property and Casualty Insurance Officer, with oversight for our property and casualty operations. From 2007 to 2010, Mr. Schell served as our Chief Underwriting Officer. Prior to joining HCC in 2002, Mr. Schell was with the St. Paul Companies for 25 years, most recently as President and Chief Operating Officer of St. Paul Re.	61	2002
Christopher J.B. Williams	Mr. Williams has served as our President since May 2011 and as a member of our Board of Directors since May 2007, including as Chairman of the Board from 2008 to May 2011. Prior to joining HCC, Mr. Williams was Chairman of Wattle Creek Winery from 2005 to May 2011. Prior to his retirement in 2005, he served as the National Director for Life, Accident & Health of Willis Re. Mr. Williams currently serves as a member of the Investment and Finance Committee and the Enterprise Risk Oversight Committee of our Board.	55	2011

Employees

At December 31, 2011, we had 1,874 employees. We are not a party to any collective bargaining agreement and have not experienced work stoppages or strikes as a result of labor disputes. We consider our employee relations to be good.

Available Information

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

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

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

Risks Relating to our Industry

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

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

The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Insurance companies are not permitted to reserve for a catastrophe until it has occurred. Catastrophes can cause losses in a variety of our property and casualty lines, and most of our past catastrophe-related claims have resulted from hurricanes and earthquakes; however, we experienced a significant loss as a result of the September 11, 2001 terrorist attack. Most of our exposure to catastrophes comes from our International segment, particularly related to our property and property treaty businesses.

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

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

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

Any of these factors could lead to a significant reduction in premium rates, less favorable policy terms and fewer opportunities to underwrite insurance risks, which could have a material adverse effect on our results of operations and cash flows. In addition to these considerations, changes in the frequency and severity of losses suffered by insureds and insurers may affect the cycles of the insurance and reinsurance business significantly. These factors may also cause the price of our common stock to be volatile.

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

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

Past events, such as the subprime credit issues, volatility in the financial markets, the economic downturn and decline in the equity markets, may result in an increase in the number of claims and the severity of the claims reported, particularly in lines of business such as directors and officers liability, errors and omissions liability and trade credit insurance. Many of these items are not directly quantifiable in advance. Additionally, there may be a significant reporting delay between the occurrence of the insured event and the time it is reported to us.

The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to our loss and loss adjustment expenses are reflected in our results of operations in the periods in which such estimates are changed. Because setting reserves is inherently uncertain, there can be no assurance that current reserves will prove adequate in light of subsequent events, particularly in volatile economic times and the often related changes in behavior of claimants and policyholders, including an increase in fraudulent reporting of exposures and/or losses, reduced maintenance of insured properties or increased frequency of small claims. If actual claims prove to be greater than our reserves, our financial position, results of operations and liquidity may be materially adversely affected.

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

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

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

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

We are subject to extensive governmental regulation.

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

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

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

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), enacted in July 2010, expands the U.S. Federal government s presence in insurance oversight. The Act s requirements include streamlining the state-based regulation of reinsurance and non-admitted insurance. This legislation also establishes a new Federal Insurance Office with powers over most lines of insurance other than health insurance. The Federal Insurance Office is authorized to gather data and information to monitor aspects of the insurance industry, identify issues in the regulation of insurers about insurance matters, and preempt state insurance measures under certain circumstances. As this Act calls for numerous studies and contemplates further regulation, the future impact of the Act on our results of operations or financial position cannot be determined at this time.

The European Union (EU) is phasing in a new regulatory regime for the regulation of financial services known as Solvency II , which is built on a risk-based approach to setting capital requirements for insurers and reinsurers. Solvency II is expected to be implemented in 2013. The impact on us from our implementation of Solvency II will depend on the costs associated with implementation by each EU country, any increased capital requirements applicable to us, and any costs associated with adjustments to our operations. In addition, the overall impact will depend on whether the U.S. regulatory regime is deemed equivalent to Solvency II, thereby reducing the costs of implementation. As such, we are currently not able to predict the impact of Solvency II on our financial position and results of operations.

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

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

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

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

Our reliance on brokers subjects us to their credit risk.

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

Consolidation in the insurance industry could adversely impact us.

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

Risks Relating to our Business

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

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

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

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

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

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

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

We purchase reinsurance by transferring, or ceding, all or part of the risk we have assumed as a direct insurer to a reinsurance company in exchange for all or part of the premium we receive in connection with the risk. Through reinsurance,

we have the contractual right to collect the amount reinsured from our reinsurers. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us, the reinsured, of our full liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers.

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

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

To the extent that reinsurers have excluded coverage for terrorist acts or have priced such coverage at rates that we believe are not practical, we, in our capacity as a direct insurer, do not have reinsurance protection and are exposed for potential losses as a result of any terrorist acts. To the extent an act of terrorism is certified by the Secretary of Treasury, we may be covered under the Terrorism Risk Insurance Program Reauthorization Act of 2007, for up to 85% of our losses in 2012 up to the maximum amount set out in the Reauthorization Act. However, any such coverage would be subject to a mandatory deductible of approximately $135.5 million in 2012.

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

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

We face competition from other specialty insurance companies, standard insurance companies and underwriting agencies, as well as from diversified financial services companies that are larger than we are and that have greater financial, marketing and other resources than we do. Some of these competitors also have longer experience and more market recognition than we do in certain lines of business. In addition, it may be difficult or prohibitively expensive for us to implement IT systems and processes that are competitive with the systems and processes of these larger companies. Furthermore, due to volatility in the financial markets and the related negative economic impact, the U.S. government has intervened in the operations of some of our competitors, which could lead to increased competition on uneconomic terms in certain of our lines of business. In addition to competition in the operation of our business, we face competition from a variety of sources in attracting and retaining qualified employees. We cannot assure that we will maintain our current competitive position in the markets in which we operate, or that we will be able to expand our operations into new markets. If we fail to do so, our results of operations and cash flows could be materially adversely affected.

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

At December 31, 2011, substantially all of our $6.0 billion investment portfolio was invested in fixed income securities. The fair value of these fixed income securities and the related investment income fluctuate depending on general economic and market conditions, including the continuing volatility in the market and economy as a whole. For our fixed income securities, the fair value generally increases or decreases in an inverse relationship with fluctuations in interest rates and credit spreads, while net investment income realized by us from future investments in fixed income securities will generally increase or decrease with interest rates. Mortgage-backed and asset-backed securities may have different net investment income and/or cash flows from those anticipated at the time of investment. These securities have prepayment risk because the timing of cash flows that result from the repayment of principal might occur earlier than anticipated, due to declining interest rates, or extension risk when cash flows may be received later than anticipated because of rising interest rates.

Although 99% of our portfolio is investment grade, all of our fixed income securities are subject to credit risk. For mortgage-backed securities, credit risk exists if mortgagors default on the underlying mortgages. During an economic downturn, our state, municipal and non-U.S. sovereign bond portfolios could be subject to a higher risk of default or impairments due to declining tax bases and revenue, notwithstanding the relatively low historical rates of default of these types of obligations. If any of the issuers of our fixed income securities suffer financial setbacks, the ratings on the fixed income securities could fall (with a concurrent fall in fair value) and, in a worst case scenario, the issuer could default on its financial obligations. If the issuer defaults, we could have realized losses associated with the impairment of the securities.

The impact of fluctuations in the market prices of securities affects our financial statements. Because the majority of our fixed income securities are classified as available for sale, changes in the fair value of our securities are reflected in our other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our financial position. The unrealized pretax net investment gains on our available for sale fixed income securities were $333.4 million, $134.6 million and $156.3 million at December 31, 2011, 2010 and 2009, respectively.

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

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

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

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

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

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

We may be unable to attract and retain qualified employees.

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

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

Our strategy for growth includes growing through acquisitions of insurance industry related companies. This strategy presents risks that could have a material adverse effect on our business and financial performance, including:

- the diversion of our management s attention,
- our ability to assimilate the operations and personnel of the acquired companies,
- the contingent and latent risks associated with the past operations of, and other unanticipated problems arising in, the acquired companies,
- the need to expand management, administration and operational systems, and
- increased competition for suitable acquisition opportunities and qualified employees.

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

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

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

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

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

Because we operate internationally, fluctuations in currency exchange rates may affect our receivable and payable balances and our reserves.

We underwrite insurance coverages that are denominated in a number of foreign currencies, and we establish and maintain our loss reserves with respect to these policies in their respective currencies. While we hold assets denominated in comparable foreign currencies to economically hedge the foreign currency risk related to these reserves and other liabilities denominated in foreign currencies, our net earnings could be adversely affected by exchange rate fluctuations if our assets do not match our liabilities. We do not use derivative contracts to hedge against foreign currency mismatches. Our principal area of exposure relates to fluctuations in exchange rates between the major European currencies (particularly the British pound sterling and the Euro) and the U.S. dollar. Consequently, a change in the exchange rate between the U.S. dollar and the British pound sterling or the Euro could have a material adverse effect on our results of operations.

Our information technology systems may fail or suffer a loss of security, which could adversely affect our business.

Our business is highly dependent upon the successful and uninterrupted functioning of our computer systems. We rely on these systems to perform actuarial and other modeling functions necessary for writing business, to process our premiums and policies, to process and make claims payments, and to prepare our management and external financial statements and information. The failure of these systems could interrupt our operations. In addition, in the event of a disaster such as a natural catastrophe, an industrial accident, a blackout, a computer virus, a terrorist attack or war, our systems may be inaccessible for an extended period of time. These systems failures or disruptions could result in a material adverse effect on our business results.

In addition, a security breach of our computer systems could damage our reputation or result in liability. We retain confidential information regarding our business dealings in our computer systems. We may be required to spend significant capital and other resources to protect against security breaches or to alleviate problems caused by such breaches. Despite the implementation of security measures, the infrastructure supporting our computer systems may be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. In addition, we could be subject to liability if hackers were able to penetrate our network security or otherwise misappropriate confidential information.

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

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

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

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

Many state insurance regulatory laws contain provisions that require advance approval by state agencies of any change of control of an insurance company that is domiciled or, in some cases, has substantial business in that state. Control is generally presumed to exist through the ownership of 10% or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. We own, directly or indirectly, all of the shares of stock of insurance companies domiciled in a number of states. Any purchaser of shares of common stock representing 10% or more of the voting power of our common stock will be presumed to have acquired control of our domestic insurance subsidiaries unless, following application by that purchaser, the relevant state insurance regulators determine otherwise. Any transactions that would constitute a change in control of any of our individual insurance subsidiaries would generally require prior approval by the insurance departments of the states in which the insurance subsidiary is domiciled. Also, one of our insurance subsidiaries is domiciled in the United Kingdom and another in Spain. Insurers in those countries are also subject to change of control restrictions under their individual regulatory frameworks. These requirements may deter or delay possible significant transactions in our common stock or the disposition of our insurance companies to third parties, including transactions that could be beneficial to our shareholders.

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

None.

Item 2. ***Properties***

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

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

Segment	Location	Square feet	Termination date of lease
U.S. Property & Casualty and Corporate headquarters	Houston, Texas	51,000	Owned
U.S. Property & Casualty	Houston, Texas	77,000	Owned
	Mount Kisco, New York	38,000	Owned
	Wakefield, Massachusetts	28,000	February 28, 2017
	Dallas, Texas	28,000	August 31, 2013
	Auburn Hills, Michigan	27,000	May 31, 2012
Accident & Health	Atlanta, Georgia	38,000	June 30, 2017
	Minneapolis, Minnesota	25,000	September 30, 2017
U.S. Surety & Credit	Los Angeles, California	40,000	October 31, 2016
International	London, England	30,000	December 24, 2015

Item 3. ***Legal Proceedings***

Litigation

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

Item 4. ***Mine Safety Disclosure***

Not applicable.

PART II

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

Price Range of Common Stock

Our common stock trades on the New York Stock Exchange under the ticker symbol HCC . The intra-day high and low sales prices for quarterly periods from January 1, 2010 through December 31, 2011, as reported by the New York Stock Exchange, were as follows:

	0000000000	0000000000	0000000000	0000000000
	2011		**2010**	
	High	**Low**	**High**	**Low**
First quarter	$ 32.00	$ 29.00	$ 29.00	$ 26.29
Second quarter	33.12	30.73	28.10	23.85
Third quarter	31.90	24.66	26.57	24.10
Fourth quarter	30.33	25.32	29.18	25.66

On February 17, 2012, the last reported sales price of our common stock as reported by the New York Stock Exchange was $29.81 per share.

Shareholders

We have one class of authorized capital stock. On February 17, 2012, there were 122.7 million shares of common stock issued and 104.0 million shares of common stock outstanding held by 653 shareholders of record; however, we estimate there are approximately 48,000 beneficial owners.

Dividend Policy

Cash dividends declared on a quarterly basis in 2011 and 2010 were as follows:

	000000000	000000000
	2011	**2010**
First quarter	$ 0.145	$ 0.135
Second quarter	0.145	0.135
Third quarter	0.155	0.145
Fourth quarter	0.155	0.145

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

Issuer Purchases of Equity Securities

On September 23, 2011, the Board approved the purchase of up to $300.0 million of our common stock (the Plan). This new authorization follows the completion of a $300.0 million share repurchase program approved on March 10, 2011. Purchases under the Plan may be made in the open market or in privately negotiated transactions from time-to-time in compliance with applicable laws, rules and regulations, including Rule 10b-18 under the Securities Exchange Act of 1934, as amended. Purchases will be made opportunistically, subject to market and business conditions, the level of cash generated from our operations, cash required for acquisitions, our debt covenant compliance, and other relevant factors. The Plan does not obligate us to purchase any particular number of shares, has no expiration date, and may be suspended or discontinued at any time at the Board s discretion. Our purchases in the fourth quarter of 2011 were as follows:

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or programs
October 1 - October 31, 2011	32,009	$26.38	32,009	$291,321,680
November 1 - November 30, 2011	1,142,898	$26.22	1,142,898	$261,355,998
December 1 - December 31, 2011	1,294,182	$27.01	1,294,182	$226,406,283
Total	2,469,089		2,469,089	

Performance Graph

The following graph shows a comparison of cumulative total returns for an investment of $100.00 made on December 31, 2006 in the common stock of HCC Insurance Holdings, Inc., the Standard & Poor s Composite 1500 Index and the Standard & Poor s 1500 Multi-Line Insurance Index. The graph assumes that all dividends were reinvested.

Total Return to Shareholders

(includes reinvestment of dividends)

Company/Index	2006	2007	2008	2009	2010	2011
HCC Insurance Holdings, Inc.	$100.00	$90.62	$86.17	$91.91	$97.10	$94.19
S&P Composite 1500 Index	100.00	105.47	66.74	84.92	98.83	100.56
S&P 1500 Multi-Line Insurance Index	100.00	87.25	11.83	15.67	19.16	14.87

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

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

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

	000000000000	000000000000	000000000000	000000000000	000000000000
			Years ended December 31,		
	2011	**2010**	**2009**	**2008**	**2007**
			(in thousands, except per share data)		
Statement of earnings data					
Revenue					
Net earned premium	$ 2,127,170	$ 2,041,924	$ 2,037,235	$ 2,007,774	$ 1,985,086
Net investment income	212,271	203,819	191,965	164,751	206,462
Other operating income	35,590	44,832	82,669	61,985	106,889
Net realized investment gain (loss)	3,653	12,104	12,076	(16,808)	13,188
Other-than-temporary impairment credit losses	(4,679)	(425)	(5,429)	(11,133)	-
Total revenue	2,374,005	2,302,254	2,318,516	2,206,569	2,311,625
Expense					
Loss and loss adjustment expense, net	1,399,247	1,213,029	1,215,759	1,211,873	1,183,947
Policy acquisition costs, net	328,134	322,046	308,554	308,587	289,862
Other operating expense	268,548	256,004	259,488	233,509	241,642
Interest expense	23,070	21,348	16,164	20,362	16,270
Total expense	2,018,999	1,812,427	1,799,965	1,774,331	1,731,721
Earnings before income tax expense	355,006	489,827	518,551	432,238	579,904
Income tax expense	99,763	144,731	164,683	130,118	188,351
Net earnings	$ 255,243	$ 345,096	$ 353,868	$ 302,120	$ 391,553
Earnings per common share					
Basic	$ 2.31	$ 3.00	$ 3.14	$ 2.63	$ 3.47
Diluted	$ 2.30	$ 2.99	$ 3.11	$ 2.61	$ 3.35
Weighted average shares outstanding					
Basic	109,051	113,863	112,200	114,848	112,873
Diluted	109,240	114,077	113,058	115,463	116,997
Cash dividends declared, per share	$ 0.60	$ 0.56	$ 0.52	$ 0.47	$ 0.42

	0000000000	0000000000	0000000000	0000000000	0000000000
			December 31,		
	2011	**2010**	**2009**	**2008**	**2007**
			(in thousands, except per share data)		
Balance sheet data					
Total investments	$ 6,049,750	$ 5,687,095	$ 5,456,229	$ 4,804,283	$ 4,672,277
Premium, claims and other receivables	688,732	635,867	600,332	770,823	763,401
Reinsurance recoverables	1,056,068	1,006,855	1,016,411	1,054,950	956,665
Ceded unearned premium	222,300	278,663	270,436	234,375	244,684
Goodwill	872,814	821,648	822,006	858,849	776,046
Total assets	$ 9,625,253	$ 9,064,082	$ 8,834,391	$ 8,332,000	$ 8,074,520
Loss and loss adjustment expense payable	3,658,317	3,471,858	3,492,309	3,415,230	3,227,080
Reinsurance, premium and claims payable	366,499	345,730	337,257	527,476	627,812
Unearned premium	1,031,034	1,045,877	1,044,747	977,426	943,946
Notes payable	478,790	298,637	298,483	343,649	319,471
Shareholders equity	$ 3,292,014	$ 3,296,432	$ 3,031,183	$ 2,640,023	$ 2,443,695
Book value per share (1)	$ 31.62	$ 28.67	$ 26.58	$ 23.27	$ 21.24
Shares outstanding	104,101	114,968	114,051	113,444	115,069

	0000000000	0000000000	0000000000	0000000000	0000000000
			Years ended December 31,		
	2011	**2010**	**2009**	**2008**	**2007**
			(in thousands, except percentage data)		
Statistical data					
Gross written premium	$ 2,649,126	$ 2,578,908	$ 2,559,791	$ 2,498,763	$ 2,451,179
Net written premium	$ 2,182,158	$ 2,026,197	$ 2,046,289	$ 2,060,618	$ 1,985,609
Net loss ratio (2)	65.8 %	59.4 %	59.7 %	60.4 %	59.6 %
Expense ratio (3)	25.0	25.2	24.3	24.7	23.9
Combined ratio	90.8 %	84.6 %	84.0 %	85.1 %	83.5 %

(1) Calculated by dividing outstanding shares into total shareholders equity.

(2) Calculated by dividing net incurred loss and loss adjustment expense by net earned premium.

(3) Calculated by dividing segment underwriting expense by segment revenue.

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

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

Overview

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain and Ireland, transacting business in approximately 180 countries. Our shares trade on the New York Stock Exchange and closed at $29.81 on February 17, 2012, resulting in market capitalization of $3.1 billion.

We underwrite a variety of relatively non correlated specialty insurance products, including property and casualty, accident and health, surety, credit and aviation product lines. We market our insurance products through a network of independent agents and brokers, managing general agents and directly to consumers. In addition, we assume insurance written by other insurance companies. We manage our businesses through five insurance underwriting segments and our Investing segment. Our insurance underwriting segments are U.S. Property & Casualty, Professional Liability, Accident & Health, U.S. Surety & Credit and International.

Our business philosophy is to maximize underwriting profit while managing risk. We concentrate our insurance writings in selected specialty lines of business in which we believe we can achieve meaningful underwriting profit. We also rely on our experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to limit or reduce risk. Our business plan is shaped by our underlying business philosophy. As a result, our primary objective is to maximize net earnings and grow book value per share, rather than to grow gross written premium or our market share.

Key facts about our consolidated group as of and for the year ended December 31, 2011 are as follows:

- We had consolidated shareholders equity of $3.3 billion, with a book value per share of $31.62.

- We generated net earnings of $255.2 million, or $2.30 per diluted share.

- We produced total revenue of $2.4 billion, of which 90% related to net earned premium and 9% related to net investment income.

- We recognized gross losses of $175.5 million and net losses, after reinsurance and reinstatement premium, of $117.9 million from catastrophes in Japan, New Zealand, the United States, Denmark and Thailand, mainly in our International segment.

- Our net loss ratio, including the catastrophe losses, was 65.8% and our combined ratio was 90.8%. The catastrophe losses increased the net loss ratio by 5.3 percentage points and the combined ratio by 5.4 percentage points.

- We recorded net adverse loss development of $10.1 million. We also recognized $37.3 million of losses related to our increase in the ultimate loss ratio for accident year 2011 for the diversified financial products line of business in our Professional Liability segment.

- We recognized $13.0 million of profit commissions due from reinsurers, related to the U.S. D&O and International D&O lines of business.

- Our debt to capital ratio was 12.7% at December 31, 2011.

We purchased $373.6 million of our common stock at an average cost of $29.55 per share. At year-end, we had $226.4 million remaining under our current $300.0 million share buyback authorization.

We increased our dividend for the 15th consecutive year and paid $65.8 million of dividends.

The following sections discuss our key operating results. The reason for any significant variations between 2010 and 2009 are the same as those discussed for variations between 2011 and 2010, unless otherwise noted. Amounts in tables are in thousands, except for earnings per share, percentages, ratios and number of employees.

Results of Operations

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

	000000000000 2011	000000000000 2010	000000000000 2009
Net earnings	$ 255,243	$ 345,096	$ 353,868
Earnings per diluted share	$ 2.30	$ 2.99	$ 3.11
Net loss ratio	65.8 %	59.4 %	59.7 %
Expense ratio	25.0	25.2	24.3
Combined ratio	90.8 %	84.6 %	84.0 %

Our 2011 and 2010 results include the impact of catastrophic events around the world. We experienced catastrophe losses primarily from the Japan earthquake and tsunami, New Zealand earthquakes, United States tornados and Hurricane Irene, Denmark storms and Thailand floods in 2011 and the Chile earthquake in 2010. We had no significant catastrophe losses in 2009. We reinsured a portion of our exposure to these catastrophic events. In 2011, we incurred $14.0 million of additional cost for net reinstatement premium to continue our reinsurance coverage for future loss events. The following table summarizes our catastrophe losses, as well as the impact on our net earnings and key metrics in 2011 and 2010.

	000000000 2011	000000000 2010
Gross losses	$ 175,468	$ 44,042
Net losses, after reinsurance and reinstatement premium	$ 117,915	$ 21,346
Impact of net catastrophe losses on:		
Net earnings per diluted share	$ (0.70)	$ (0.12)
Net loss ratio (percentage points)	5.3 %	1.1 %
Combined ratio (percentage points)	5.4 %	1.1 %

In addition to the catastrophe losses, we increased our loss reserves by $47.4 million in 2011 to reflect the impact of net adverse prior year loss development and the additional accident year 2011 losses related to our diversified financial products (DFP) line of business. Adverse (favorable) loss development was $10.1 million, $(22.7) million and $(53.5) million for 2011, 2010 and 2009, respectively, and the DFP losses totaled $37.3 million. See the Segment Operations section below for further discussion of the catastrophes, loss development and DFP accident year 2011 losses.

Revenue

We generate our revenue from five primary sources:

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

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

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

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

- realized investment gains and losses related to our fixed income securities portfolio.

Total revenue increased $71.8 million in 2011, compared to 2010, primarily due to higher net earned premium and net investment income, offset by lower other operating income and net realized investment gains. Total revenue decreased $16.3 million in 2010, compared to 2009, due to lower other operating income, partially offset by increased investment income from growth in our investment portfolio. Other operating income in 2009 included $25.0 million related to termination of a reinsurance contract, which is discussed below.

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

	00000000000 **2011**	00000000000 **2010**	00000000000 **2009**
U.S. Property & Casualty	$ 540,436	$ 538,475	$ 603,408
Professional Liability	562,503	596,291	639,469
Accident & Health	802,302	761,729	745,035
U.S. Surety & Credit	226,312	226,866	203,522
International	517,383	453,478	337,562
Exited Lines	190	2,069	30,795
Total gross written premium	$ 2,649,126	$ 2,578,908	$ 2,559,791
U.S. Property & Casualty	$ 367,296	$ 328,821	$ 382,807
Professional Liability	412,262	401,562	447,080
Accident & Health	801,731	761,373	744,554
U.S. Surety & Credit	208,859	209,373	189,208
International	391,819	324,344	253,060
Exited Lines	191	724	29,580
Total net written premium	$ 2,182,158	$ 2,026,197	$ 2,046,289
U.S. Property & Casualty	$ 333,410	$ 339,513	$ 379,439
Professional Liability	410,816	425,226	444,534
Accident & Health	803,462	760,034	741,539
U.S. Surety & Credit	210,535	199,908	182,627
International	368,748	316,186	256,122
Exited Lines	199	1,057	32,974
Total net earned premium	$ 2,127,170	$ 2,041,924	$ 2,037,235

The 2011 and 2010 growth in premium from our insurance underwriting segments occurred primarily in the International segment, directly related to our new property treaty business, and in the Accident & Health segment, related to our medical stop-loss product. See the Segment Operations section below for further discussion of the relationship and changes in premium revenue within each segment.

Net investment income, which is included in our Investing segment, increased 4% in 2011 and 6% in 2010, primarily due to higher income from fixed income securities, generated from an increased amount of investments and improved management of short-term funds. Our fixed income securities portfolio increased 13% in 2011 and 12% in 2010, from $4.6 billion at December 31, 2009 to $5.2 billion at December 31, 2010 and $5.9 billion at December 31, 2011. The growth in fixed income securities resulted primarily from cash flow from operations and long-term investment of short-term funds. Short-term investment income declined due to lower average short-term investment balances in 2010 and 2011.

The sources of net investment income are detailed below.

	0000000000 2011	0000000000 2010	0000000000 2009
Fixed income securities			
Taxable	$ 113,293	$ 110,517	$ 106,690
Exempt from U.S. income taxes	98,729	92,297	82,760
Total fixed income securities	212,022	202,814	189,450
Short-term investments	537	900	1,978
Other	4,486	4,344	4,338
Total investment income	217,045	208,058	195,766
Investment expense	(4,774)	(4,239)	(3,801)
Net investment income	$ 212,271	$ 203,819	$ 191,965

The following table details the components of our other operating income.

	2011	2010	2009
Fee and commission income	$ 32,933	$ 33,237	$ 46,207
Financial instruments	659	8,767	4,703
Contract using deposit accounting	-	-	25,532
Other	1,998	2,828	6,227
Other operating income	$ 35,590	$ 44,832	$ 82,669

Fee and commission income, which relates to third party agency and broker commissions, has declined since 2009, primarily due to reduced brokerage volume in our International segment following the sale of our U.K. reinsurance broker in late 2009. The financial instruments line, which relates to two derivative contracts denominated in British pound sterling, includes the effect of foreign currency fluctuations compared to the U.S. dollar. In 2010, this line also included an $8.0 million gain related to terminating one of these derivative contracts. The contract using deposit accounting line includes a $25.0 million fee we received in 2009 for terminating all of our liability, loss-free, under a reinsurance contract that had been accounted for using the deposit method of accounting. Our $25.0 million fee was partially offset by $9.9 million of expenses for reinsurance and other direct costs, which were included in other operating expense. The income from terminating the derivative and reinsurance contracts is included in our U.S. Property & Casualty segment.

Loss and Loss Adjustment Expense

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

Loss development represents an increase or decrease in estimates of ultimate losses related to business written in prior accident years. Such increases or decreases are recorded as loss and loss adjustment expense in the current reporting year. A redundancy, also referred to as favorable development, means the original ultimate loss estimate was higher than the current estimate. A deficiency, or adverse development, means the current ultimate loss estimate is higher than the original estimate.

The tables below detail, by segment, our net loss and loss adjustment expense, the amount of development included in our net loss and loss adjustment expense, and our net loss ratios.

	0000000000 **2011**	0000000000 **2010**	0000000000 **2009**
U.S. Property & Casualty	$ 201,017	$ 191,108	$ 201,311
Professional Liability	328,503	265,465	276,558
Accident & Health	586,210	556,848	540,917
U.S. Surety & Credit	52,206	52,940	54,618
International	233,879	143,412	94,550
Exited Lines	(2,568)	3,256	47,805
Net loss and loss adjustment expense	$ 1,399,247	$ 1,213,029	$ 1,215,759
Adverse (favorable) development:			
U.S Property & Casualty	$ (3,145)	$ (15,891)	$ (25,942)
Professional Liability	47,084	9,624	(674)
Accident & Health	(6,094)	9,840	3,061
U.S. Surety & Credit	(11,300)	(7,181)	(10,497)
International	(13,830)	(22,277)	(30,894)
Exited Lines	(2,568)	3,222	11,422
Total adverse (favorable) development	10,147	(22,663)	(53,524)
Catastrophe losses	103,907	22,500	-
All other net loss and loss adjustment expense	1,285,193	1,213,192	1,269,283
Net loss and loss adjustment expense	$ 1,399,247	$ 1,213,029	$ 1,215,759
U.S. Property & Casualty	60.3 %	56.3 %	53.1 %
Professional Liability	80.0	62.4	62.2
Accident & Health	73.0	73.3	72.9
U.S. Surety & Credit	24.8	26.5	29.9
International	63.4	45.4	36.9
Consolidated net loss ratio	65.8 %	59.4 %	59.7 %
Consolidated accident year net loss ratio	65.3 %	60.4 %	62.3 %

Loss and loss adjustment expense increased 15% in 2011 and had minimal change from 2009 to 2010. The 2011 increase was driven by $103.9 million of catastrophe losses, primarily in the International segment, and the $37.3 million increase of reserves for our DFP line of business in the Professional Liability segment, noted above. We experienced a corresponding increase in our consolidated accident year net loss ratio in 2011. See the Segment Operations section below for additional discussion of the changes in our loss and loss adjustment expense, development and net loss ratios for each segment.

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

	2011	2010	2009
Net reserves for loss and loss adjustment expense payable at beginning of year	$ 2,537,772	$ 2,555,840	$ 2,416,271
Net reserve additions from acquired businesses	6,261	8,110	36,522
Foreign currency adjustment	(6,108)	(21,127)	25,067
Net loss and loss adjustment expense	1,399,247	1,213,029	1,215,759
Net loss and loss adjustment expense payments	(1,253,689)	(1,218,080)	(1,137,779)
Net reserves for loss and loss adjustment expense payable at end of year	$ 2,683,483	$ 2,537,772	$ 2,555,840
Net paid loss ratio	58.9 %	59.7 %	55.8 %

Our net paid loss ratio decreased slightly in 2011, with offsetting changes in the amount of claims paid across our different lines of business. Our paid loss ratio increased in 2010, primarily due to higher claims payments for our D&O and medical stop-loss products. We commuted certain loss reserves included in our Exited Lines for $43.7 million, $15.8 million and $43.9 million, in 2011, 2010, and 2009, respectively. The commutations had no material effect on net earnings but increased our net paid loss ratios. The amount of claims paid fluctuates period to period due to our mix of business and the timing of claims settlement and catastrophic events.

Policy Acquisition Costs

Policy acquisition costs relate to direct costs we incur to issue insurance policies, including commissions, premium taxes and compensation of our underwriters. The percentage of policy acquisition costs to net earned premium was 15.4% in 2011, 15.8% in 2010 and 15.1% in 2009. The lower percentages in 2011 and 2009 primarily related to reinsurance profit commissions, which are recorded as a reduction of policy acquisition costs, of $17.2 million in 2011, $1.6 million in 2010 and $10.6 million in 2009. After excluding profit commissions, the 2011 increase primarily related to higher commission and premium tax expense due to changes in the mix of business.

Other Operating Expense

Other operating expense, of which approximately 65% relates to compensation and benefits of our 1,874 employees, increased 5% in 2011 and decreased 1% in 2010. The 2011 increase was primarily due to higher compensation and benefits and information technology expense. In 2009, we sold our U.K. reinsurance broker and our commercial marine agency business, which reduced our other operating expense in 2010. Our other operating expense included $3.0 million in 2010 and $9.9 million in 2009 of direct costs related to terminating the derivative contract and reinsurance contract, respectively, discussed above. We recognized a foreign currency benefit of $1.1 million in 2011, compared to expense of $1.6 million in 2010 and a benefit of $0.6 million in 2009.

Other operating expense included $12.4 million, $13.6 million and $16.0 million in 2011, 2010 and 2009, respectively, of stock-based compensation expense, after the effect of the deferral and amortization of policy acquisition costs related to stock-based compensation for our underwriters. Stock-based compensation expense was lower in 2011 and 2010 due to the forfeiture of restricted stock grants and full vesting of certain stock options. In 2011, we granted $13.9 million of restricted stock awards and units, with a weighted-average life of 4.1 years. At December 31, 2011, there was approximately $25.7 million of total unrecognized compensation expense related to unvested options and restricted stock awards and units that is expected to be recognized over a weighted-average period of 3.0 years. In 2012, we expect to recognize $9.8 million of expense, including the amortization of deferred policy acquisition costs, for all stock-based awards outstanding at year-end 2011.

Interest Expense

Interest expense on debt and short-term borrowings increased $1.7 million in 2011 and $5.2 million in 2010. The increase in 2011 related to $180.0 million of net borrowings during the year on our $600.0 million Revolving Loan Facility. In the fourth quarter of 2009, we issued $300.0 million of 6.30% Senior Notes, with an effective interest rate of 6.37%, and redeemed $124.7 million of 1.30% Convertible Notes. Our 2011 and 2010 interest expense includes $19.3 million for the Senior Notes.

Income Tax Expense

Our income taxes are due to U.S. Federal, state, local and foreign jurisdictions. Our effective income tax rate was 28.1% for 2011, compared to 29.5% for 2010 and 31.8% for 2009. The lower effective rate in 2011 and 2010 related to the increased benefit from higher tax-exempt investment income over the three-year period relative to a declining pretax income base over the same period.

Segment Operations

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

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

U.S. Property & Casualty Segment

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

	0000000000 **2011**	0000000000 **2010**	0000000000 **2009**
Net earned premium	$ 333,410	$ 339,513	$ 379,439
Other revenue	23,951	31,201	53,105
Segment revenue	357,361	370,714	432,544
Loss and loss adjustment expense, net	201,017	191,108	201,311
Other expense	110,184	103,229	115,198
Segment expense	311,201	294,337	316,509
Segment pretax earnings	$ 46,160	$ 76,377	$ 116,035