Ultimate Parent: HCC Insurance Holdings, Inc

HOUSTON CASUALTY COMPANY

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AMB#: 03286 **NAIC#:** 42374
Ultimate Parent#: 58391 **FEIN#:** 74-2195939

BEST'S RATING

Based on our opinion of the consolidated Financial Strength of the property/casualty members of Houston Casualty Group, which operate under a group structure, each group member is assigned a Best's Rating of A+ (Superior). The company is assigned the Financial Size Category of Class XIV, which is the Financial Size Category of the group.

RATING RATIONALE

The following text is derived from the report of Houston Casualty Group.

Rating Rationale: The rating reflects Houston Casualty Group's ("the group") sustained profitability and solid level of capitalization, while also recognizing the financial flexibility and support provided by its publicly traded parent, HCC Insurance Holdings, Inc. (HCC). The rating is also indicative of the group's near-term earnings prospects considering HCC's strong position in the specialty admitted and non-admitted market segments. Partially offsetting these positive rating factors is HCC's historically above-average ceded leverage, and the additional risk caused by increasing net premium retention levels. The rating outlook reflects A.M. Best's expectation for continued underwriting and operating profitability over the near term.

The rating is supported by the group's conservative underwriting, investment and loss reserving strategies that have led to its long-term operating profitability, while also being the primary driver for its considerable balance sheet strength. Over the past several years, the group's underwriting and operating results have consistently been outstanding. Much of HCC's success stems from the group's well-defined, specialty lines business strategy and its optimum utilization of reinsurance. This strategy has led to an above-average ceded leverage position, although this leverage has been declining in recent years as the group has increased its net premium retention. Additionally, the group's utilization of high-quality reinsurers, and its proactive approach to monitoring the quality of its recoverables somewhat tempers A.M. Best's concern over ceded leverage. The rating also recognizes HCC's growth over the past five years via an expansion in the diversified financial products segment comprised of professional liability and surety coverage, and its resulting impact on net underwriting leverage. The group's overall capitalization, although remaining solid, had weakened somewhat over the last few years due to the level of premium growth and commensurate growth in related liabilities, before improving markedly in 2007, the result of another excellent year of earnings production. As expected, underwriting leverage has stabilized during the most recent calendar years as a more than commensurate level of surplus appreciation has offset net premium growth. The group also remains exposed to large catastrophe losses due to its property and energy lines of business. On a net basis, catastrophe exposure is significantly moderated by the group's purchase of catastrophe reinsurance.

Best's Rating: A+ g **Outlook: Stable**

FIVE YEAR RATING HISTORY

Date	Best's Rating
07/30/08	A+ g
04/15/08	A+ g
01/04/07	A+ g
11/22/06	A+ gu
06/09/06	A+ g
06/28/05	A+ g
06/29/04	A+ g

KEY FINANCIAL INDICATORS

	Statutory Data ($000)		
Period Ending	Direct Premiums Written	Net Premiums Written	Pretax Operating Income
2003	484,283	422,279	24,763
2004	563,332	471,045	33,920
2005	474,513	499,452	7,331
2006	409,185	485,571	175,955
2007	383,293	424,862	172,199
09/2007	299,328	328,648	146,288
09/2008	309,043	293,423	139,814

	Statutory Data ($000)		
Period Ending	Net Income	Total Admitted Assets	Policy-holders' Surplus
2003	16,168	1,261,854	409,466
2004	18,526	1,663,676	604,394
2005	4,655	2,235,101	812,520
2006	160,833	2,520,418	952,083
2007	136,605	2,781,997	1,260,208
09/2007	110,324	2,749,911	1,170,286
09/2008	94,737	2,952,263	1,392,820

	Profitability			Leverage			Liquidity	
Period Ending	Comb. Ratio	Inv. Yield (%)	Pretax ROR (%)	NA Inv Lev	NPW to PHS	Net Lev	Overall Liq (%)	Oper. Cash-flow (%)
2003	96.5	5.5	7.8	4.1	1.0	2.9	163.8	289.4
2004	96.9	3.1	8.1	-1.5	0.8	2.4	166.1	224.5
2005	105.9	2.5	1.5	14.1	0.6	2.3	164.9	317.3
2006	82.3	4.3	35.4	18.8	0.5	2.1	165.2	206.9
2007	80.1	3.2	38.0	14.7	0.3	1.5	185.1	134.0
5-Yr Avg	92.0	3.5	19.1	…	…	…	…	…
09/2007	76.6	XX	43.0	XX	0.4	1.7	178.1	149.5
09/2008	74.4	XX	46.0	XX	0.3	1.4	194.6	151.4

(*) Data reflected within all tables of this report has been compiled from the company-filed statutory statement. Within several financial tables of this report, this company is compared against the Professional Surplus Lines Writers.

BUSINESS REVIEW

The following text is derived from the report of Houston Casualty Group.

The insurance companies comprising the HCC Insurance Group provide group life, accident and health, aviation, property, marine, energy, directors' and officers' liability, professional liability, surety and other specialty lines coverages through the group's lead carrier, Houston Casualty Company (HC) and its affiliates. HC's operation includes those of a branch office in London, England.

The group's business is produced directly and through independent agents and brokerage operations on a worldwide basis. HCC Insurance Holdings, Inc.'s (HCC) [NYSE: HCC] affiliated underwriting agencies act on behalf of both unaffiliated and affiliated insurance companies to provide insurance underwriting management and claim administration services while its reinsurance and insurance brokers provide a variety of additional services such as marketing, placing, consulting on and servicing risks for their clients. Aviation coverage is marketed to offshore operations, corporations, cargo operations, commuter airlines, governments and private aircraft owners on both a domestic and international basis. Facilities are currently dedicated to the handling of aircraft hull and liability insurance. In addition to conventional corporate and personal aircraft, the group covers specialty types, such as sport and antique airplanes, amphibians and seaplanes.

HCC provides accident and health coverages that are marketed through an affiliated underwriting agencies and directly through unaffiliated agents, brokers and third-party administrators. Property coverage is provided to large multinational corporations through HC's London branch office. The London branch also underwrites marine hull and liability coverage for ocean-going vessels, as well as onshore and offshore energy coverage for large oil companies and drilling contractors. Many of the policy forms are manuscript and tailored to meet the needs of the insured. Assumed reinsurance consists of accident and health reinsurance coverage, facultative aviation, and property and energy reinsurance issued by local companies in order to satisfy licensing requirements. Directors' and officers' liability and professional liability insurance is written through acquired underwriting agencies. Surety operations are consolidated within HCC Surety Group via American Contractors Indemnity Company (ACIC), United States Surety Company (USSC), Pioneer General Insurance Company (Pioneer General), Seguros y Reaseguros S.A. (HCCE), HCC International Insurance Company PLC (HCCI) and U.S. Specialty Insurance Company (USSIC).

In January of 2004, HCC sought to increase its specialty lines platform via the acquisition of Surety Associates Holdings Company, Inc., the parent company of ACIC. ACIC specializes in court, specialty contract, license and permit, and bail bonds. In February of 2005, HCC acquired USSC via the purchase of USSC Holdings, Inc., the privately held parent company of USSC. USSC is a Maryland-domiciled carrier specializing in writing surety bonds for small-to medium-sized contractors. In December of 2005, HCC purchased MIC Life Insurance Corporation, a Delaware-domiciled company specializing in medical stop-loss business. HCC continued to expand its surety platform in 2007 through the acquisition of Colorado-based Pioneer General, a specialty underwriter specializing in bail and civil bonds.

Workers' compensation coverage had been written by the group through USSIC, but during 2001, management decided to exit this line of business due to loss ratio and expense issues that were adversely impacting profitability. In 2001, the affiliated underwriting agencies writing workers' compensation and aviation business were consolidated with USSIC's operations. In December 1999, HCC completed the acquisition of Centris, a leading provider of medical stop-loss coverage through Centris Life Insurance Company (Centris Life) and U.S. Benefits. Subsequently, HCC contributed Centris Life to HC and renamed it HCC Life Insurance Company (HCC Life). Following the acquisition of the Centris Group, HCC became one of the largest providers of medical stop-loss coverage in the United States. HCC currently markets medical stop-loss coverage through Avemco Insurance Company (AIC) and HCC Life. Since 2003, the company continued transferring medical stop-loss business from AIC to HCC Life. Employers purchase the medical stop-loss coverage to help limit their exposure under self-insured health plans. In 2002, HCC Specialty Insurance Company (HCCSpl) was also established as an Oklahoma-domiciled subsidiary of AIC. HCCSpl's purpose is to allow HCC to write surplus lines business in Texas that HC cannot write since it is a Texas-domiciled insurer.

HCC supplements the activities of its risk-bearing companies with underwriting agencies and brokers who write on behalf of its insurance carriers and, in certain situations, other non-affiliated companies. These organizations generate fee-service income and profit commissions for the group while bearing no insurance risk. The principal agencies operating within HCC are Covenant Underwriters, Ltd. (Covenant), HCC Global Financial Products (HCCG), HCC Indemnity Guaranty Agency (HCCIG), HCC Specialty Underwriters, Inc. (HCCSU), and Professional Indemnity Agency, Inc. (PIA). The underwriting agencies specialize in the various lines of business written by the group's insurance carriers.

HCC has made numerous strategic transactions in recent years that have furthered its overall business strategy. In June of 2006, the company acquired Novia Underwriters, Inc., an underwriting agency based in Indianapolis, Indiana that specializes in medical stop-loss insurance. Novia's business has since been absorbed into Perico Life Insurance Company (PLIC). The following month the company acquired G.B. Kenrick & Associates, Inc. a Michigan-based underwriting agency specifically focused on public entity insurance. During the fourth quarter of 2006, HCC acquired the assets of the Health Products division of Allianz life Insurance Company of North America. This entity's business include medical stop-loss and medical excess insurance. HCC acquired MultiNational Underwriters (MNU) in January, 2008. MNU is an underwriting agency based in Indianapolis, Indiana.

Previously, in 2005, HCC acquired the remaining 66% of De Montfort Group Limited that it did not own. The key operating subsidiary of De Montfort Group was DMI, a provider of surety and credit insurance in the United Kingdom, allowing the group to further enhance its diversified financial product platform and its geographic base. In 2005, DMI was renamed HCC International Insurance Company PLC. Late in 2005, the company acquired Perico, Ltd., a medical stop-loss insurance underwriting agency domiciled in St. Louis, Missouri, and MIC Life Insurance Corporation (MIC), a Delaware-domiciled company. MIC was renamed Perico Life Insurance Company and was re-located to Missouri. In 2002, HCC acquired St. Paul Espana located in Madrid, Spain. This company provides directors' and officers' liability, professional liability and surety coverage utilizing a very experienced management team. St. Paul Espana now operates as HCC Europe.

2007 BUSINESS PRODUCTION AND PROFITABILITY ($000)

Product Line	Premiums Written Direct	Premiums Written Net	% of Total NPW	Pure Loss Ratio	Loss & LAE Reserves
Oth Liab Cl-Made	204,656	220,988	52.0	38.3	482,787
Ocean Marine	113,885	56,259	13.2	62.9	119,331
Oth Liab Occur	…	32,809	7.7	47.5	47,671
Aircraft	23,428	25,602	6.0	42.2	35,790
Com'l MultiPeril	-1	24,038	5.7	45.4	14,691
Allied Lines	3,174	10,360	2.4	53.8	32,628
Group A & H	7,078	10,012	2.4	110.4	356,771
Credit	10,440	9,990	2.4	49.9	6,779
All Other	20,632	34,803	8.2	14.2	59,108
Totals	383,293	424,862	100.0	43.4	1,155,555

Major 2007 Direct Premium Writings By State ($000): Louisiana, $67,002 (17.5%); California, $64,136 (16.7%); Texas, $35,715 (9.3%); New York, $26,246 (6.8%); Florida, $15,825 (4.1%); 49 other jurisdictions, $147,132 (38.4%); Canada, $1,646 (0.4%); Aggregate Alien, $25,591 (6.7%).

FINANCIAL PERFORMANCE

The following text is derived from the report of Houston Casualty Group.

Overall Earnings: On a five-year basis, the group's pre-tax and after-tax returns moderately surpass the average produced by the industry composite. This level of performance is driven by the group's underwriting discipline, expense ratio advantage and the sizeable income garnered from its investment portfolio of over $3.4 billion. Despite overall market softening that has caused margin compression in recent years, the group has focused on specific lines of business it feels still offer profit potential. These more desirable lines of business have included the group's core aviation and accident and health segments, along with the more newly emphasized surety and professional liability lines of business.

Following a few years where calendar year profits were somewhat lessened by catastrophe-driven losses, operating results for the last two years have benefited from relatively benign catastrophe activity. Though these events added points to the group's combined ratio, overall results have remained very profitable. Increased net investment income has also helped drive the improving profits. A small amount of adverse reserve development has had a very minimal, limiting impact on operating profits.

Competitive market pressures in recent years have compressed the group's profit margins on certain lines of business. Aggressive competition has led to the group placing less emphasis on directors' and officers' liability business while focusing on increased opportunities and more favorable profit margins on surety and professional indemnity business. This has led to increased retentions and more focus on these lines of coverage. Management has historically been able to limit the impact of pricing pressures on its bottom-line during periods of extreme competition through the increased utilization of reinsurance, primarily facultative placements, and the takedown of prior year loss reserves. Substantial growth in the group's net invested asset base has fueled a commensurate increase in net investment income, further augmenting calendar year operating earnings. A.M. Best believes the group will continue to generate solid earnings despite market softening in some areas because of its diversification and ability to focus on lines of business less impacted by current market pressures. Considering the group's successful history in managing the cycle and its steadfast application of conservative operating fundamentals, A.M. Best believes operating results will remain favorable.

PROFITABILITY ANALYSIS

	Company				Industry Composite			
Period Ending	Pretax ROR (%)	Return on PHS(%)	Comb. Ratio	Oper. Ratio	Pretax ROR (%)	Return on PHS(%)	Comb. Ratio	Oper. Ratio
2003	7.8	6.5	96.5	83.4	20.7	19.5	95.2	82.2
2004	8.1	12.0	96.9	88.7	14.6	11.4	95.3	83.3
2005	1.5	9.5	105.9	97.6	18.8	12.0	94.3	80.2
2006	35.4	10.2	82.3	65.2	33.1	18.2	81.1	65.4
2007	38.0	25.6	80.1	63.8	39.6	17.9	79.4	61.4
5-Yr Avg	19.1	14.6	92.0	79.3	26.1	15.9	88.4	73.7
09/2007	43.0	XX	76.6	57.8	XX	XX	XX	XX
09/2008	46.0	XX	74.4	54.9	XX	XX	XX	XX

Underwriting Income: Over the last five years, the group's underwriting performance has been very strong as evidenced by a combined ratio during that period that is comfortably better than that of the industry composite. A distinct loss ratio advantage, relative to the composite, has led to the well above-average historical underwriting performance. Solid results in core lines of business, partially offset by less favorable performance on the discontinued lines of business, drives the long-term favorable underwriting results.

The group has produced a net underwriting profit for six consecutive years, with the substantial profits being realized during the last two years in particular. This period of strong results has been produced despite the fact HCC has negotiated various reinsurance commutations, leading to the recording of additional losses and loss adjustment expenses as a result of the discount related to the commutations, primarily for the discontinued, assumed accident and health class of business. Unfavorable loss reserve development on the accident & health line, principally stemming from the commutations, and to a lesser extent, adverse development on the commercial multiple peril line of business negatively impacted the still strong underwriting results. The group's combined ratio has historically benefited from a large amount of ceding commission, largely offsetting commissions paid on direct and assumed business. Increasing net retentions, however, have tempered the positive impact of ceding commissions in recent years. A.M. Best expects HCC's long-held underwriting discipline to allow the group to sustain the favorable underwriting and operating results even as segments of the market face greater price competition.

UNDERWRITING EXPERIENCE

Year	Net Undrw Income ($000)	Loss Ratios: Pure Loss	LAE	Loss & LAE	Expense Ratios: Net Comm	Other Exp.	Total Exp.	Div. Pol.	Comb Ratio
2003	-16,314	66.7	3.8	70.4	21.3	4.8	26.1	…	96.5
2004	-833	66.5	2.9	69.4	22.6	4.8	27.5	…	96.9
2005	-33,067	71.4	4.5	75.9	23.3	6.7	30.1	…	105.9
2006	90,950	51.5	4.7	56.2	20.9	5.1	26.1	…	82.3
2007	98,128	43.4	8.6	52.0	20.7	7.4	28.1	…	80.1
5-Yr Avg	…	59.4	5.0	64.4	21.8	5.8	27.6	0.0	92.0
09/2007	82,391	44.7	7.3	52.1	XX	XX	24.5	…	76.6
09/2008	80,352	39.5	9.5	49.0	XX	XX	25.4	…	74.4

Investment Income: The group's increased premium level, higher retentions, the increase in the payout period for claims due to the writing of more longer-tail business, and the impact of reinsurance commutations have combined to produce improved operating cash flows in recent years. These cash flows have driven growth in both the invested asset base and net investment income. The group's invested asset portfolio is predominately concentrated in high-quality fixed-income securities, with an emphasis on municipal bonds, asset-backed and mortgage-backed securities, corporate bonds and to a lesser extent, treasury securities. The predominant portion of the group's investment leverage stems from its common stock holdings of affiliated companies and will remain as such given the group's business model and related business strategies. A minimal amount of equity holdings are maintained, particularly in comparison to the composite. Overall, HCC maintains relatively conservative investment leverage.

The average maturity of the fixed-income portfolio has consistently been maintained at approximately five to six years. Over the past five years, the group's investment portfolio has generated an investment yield that is slightly below that of the industry composite, as is its average return on invested assets over that same time period.

INVESTMENT INCOME ANALYSIS ($000)

Year	Company: Net Inv Income	Realized Capital Gains	Unrealized Capital Gains
2003	41,519	5,618	10,271
2004	34,373	4,254	42,544
2005	40,312	10,453	62,519
2006	85,123	31,236	-71,188
2007	73,895	12,319	146,358
09/2007	63,836	4,612	99,289
09/2008	59,102	-6,053	58,148

Year	Company: Inv Inc Growth (%)	Inv Yield (%)	Total Return (%)	Industry Composite: Inv Inc Growth (%)	Inv Yield (%)
2003	58.1	5.5	7.7	16.4	4.4
2004	-17.2	3.1	7.4	3.6	3.7
2005	17.3	2.5	7.2	18.5	3.8
2006	111.2	4.3	2.2	27.5	4.3
2007	-13.2	3.2	10.5	12.9	4.4
5-Yr Avg	20.9	3.5	6.9	16.0	4.2
09/2007	XX	XX	7.5	XX	XX
09/2008	XX	XX	4.4	XX	XX

INVESTMENT PORTFOLIO ANALYSIS

Asset Class	2007 Inv Assets ($000)	% of Invested Assets 2007	2006	Annual % Chg
Long-Term bonds	1,501,491	59.5	57.9	21.4
Stocks	49,091	1.9	2.8	-18.8
Affiliated Investments	650,755	25.8	23.6	29.1
Other Inv Assets	323,281	12.8	15.6	-3.3
Total	2,524,618	100.0	100.0	18.2

2007 BOND PORTFOLIO ANALYSIS

Asset Class	% of Total Bonds	Mkt Val to Stmt Val(%)	Avg. Maturity (Yrs)	Class 1 - 2 (%)	Class 3 - 6 (%)	Struc. Secur. (%)	Struc. Secur. (% of PHS)
Governments	9.8	1.2	1.0	100.0	…	…	…
States, terr & poss	68.6	1.2	6.9	100.0	…	11.4	10.1
Corporates	21.6	-0.3	4.6	99.4	0.6	38.0	10.6
Total all bonds	100.0	0.8	5.8	99.9	0.1	16.0	20.8

CAPITALIZATION

The following text is derived from the report of Houston Casualty Group.

The considerable appreciation in the group's policyholders' surplus has predominantly been driven by operating earnings, capital contributions from the parent company and both realized and unrealized gains. Surplus growth has been constrained somewhat by dividends paid to the parent, however, the contributed dividends have decreased a little in the last two calendar years. Excellent operating results in recent years coupled with capital contributions from the parent holding company have enabled capitalization to adequately support the group's growth in premiums written.

The group has produced strong earnings via increased earned premium from its increasing net retentions of recent years. This is a solid indication that the group has effectively seized opportunities to generate revenue on business where market competition remains reasonable and favorable profit margins still exist.

Over the past several years, the group's significant growth, particularly during the during the 2001-2004 hard-market period, led to slightly weakened risk-adjusted capitalization by the end of that period. However, the group's capital position has always remained supportive of its rating, as measured by Best's Capital Adequacy Ratio (BCAR). The decline in risk-adjusted capitalization reflected both significant growth in net premium volume along with commensurate growth in net loss reserves and ceded reinsurance recoverables. Despite these increases, premium and loss reserve leverage measures remain on par with or slightly conservative, relative to the industry composite, primarily due to the impact of the parent company capital contributions.

The strong cash flow of HCC has been enough to cover its operating and dividend requirements. A.M. Best does not anticipate the level of dividends paid by the group's insurance companies to the parent to materially weaken the capitalization of these subsidiaries.

CAPITAL GENERATION ANALYSIS ($000)

	Source of Surplus Growth		
Year	Pretax Operating Income	Total Inv. Gains	Net Contrib. Capital
2003	24,763	15,889	765
2004	33,920	46,798	95,791
2005	7,331	72,972	146,900
2006	175,955	-39,952	18,464
2007	172,199	158,676	1,207
5-Yr Total	414,168	254,383	263,128
09/2007	146,288	103,901	381
09/2008	139,814	52,095	821

	Source of Surplus Growth		
Year	Other, Net of Tax	Change in PHS	PHS Growth (%)
2003	-32,598	8,819	2.2
2004	18,419	194,928	47.6
2005	-19,077	208,126	34.4
2006	-14,904	139,563	17.2
2007	-23,958	308,125	32.4
5-Yr Total	-72,117	859,561	…
09/2007	-32,366	218,203	22.9
09/2008	-60,118	132,612	10.5

QUALITY OF SURPLUS ($000)

		% of PHS			Dividend Requirements		
Year	Year-End PHS	Cap Stk/ Contrib. Cap.	Other	Un-assigned Surplus	Stock-holder Divs	Div to POI (%)	Div to Net Inc. (%)
2003	409,466	74.8	…	25.2	…	…	…
2004	604,394	66.5	…	33.5	…	…	…
2005	812,520	67.6	…	32.4	…	…	…
2006	952,083	59.6	…	40.4	…	…	…
2007	1,260,208	45.5	…	54.5	…	…	…
09/2007	1,170,286	48.5	…	51.5	…	…	…
09/2008	1,392,820	41.2	…	58.8	…	…	…

LEVERAGE ANALYSIS

	Company				Industry Composite			
Year	NPW to PHS	Reserves to PHS	Net Lev	Gross Lev	NPW to PHS	Reserves to PHS	Net Lev	Gross Lev
2003	1.0	0.9	2.9	6.2	0.7	1.0	2.6	4.2
2004	0.8	1.0	2.4	4.9	0.7	1.1	2.5	4.0
2005	0.6	1.2	2.3	4.2	0.6	1.1	2.4	3.9
2006	0.5	1.2	2.1	3.4	0.6	1.1	2.3	3.6
2007	0.3	0.9	1.5	2.3	0.5	1.0	2.0	3.0
09/2007	0.4	1.0	1.7	XX	XX	XX	XX	XX
09/2008	0.3	0.8	1.4	XX	XX	XX	XX	XX

Current BCAR: 226.3

PREMIUM COMPOSITION & GROWTH ANALYSIS

Period	DPW		GPW	
Ending	($000)	(% Chg)	($000)	(% Chg)
2003	484,283	106.7	909,775	85.6
2004	563,332	16.3	927,909	2.0
2005	474,513	-15.8	833,566	-10.2
2006	409,185	-13.8	738,596	-11.4
2007	383,293	-6.3	664,564	-10.0
5-Yr CAGR	…	10.3	…	6.3
5-Yr Change	…	63.6	…	35.6
09/2007	299,328	-8.1	511,930	-9.8
09/2008	309,043	3.2	464,083	-9.3

Period	NPW		NPE	
Ending	($000)	(% Chg)	($000)	(% Chg)
2003	422,279	84.5	317,033	75.3
2004	471,045	11.5	420,427	32.6
2005	499,452	6.0	485,539	15.5
2006	485,571	-2.8	496,968	2.4
2007	424,862	-12.5	453,470	-8.8
5-Yr CAGR	…	13.2	…	20.2
5-Yr Change	…	85.7	…	150.7
09/2007	328,648	-10.4	340,108	-9.7
09/2008	293,423	-10.7	303,716	-10.7

Reserve Quality: From a calendar year perspective, the group has reported unfavorable loss reserve development in recent years, primarily impacting accident years 1998-2002, and largely driven by the commutation of reinsurance recoverables in 2003, 2005 and 2006. The increased loss totals are attributable to late reporting of claims by cedants and state guaranty associations, in addition to changes in actuarial assumptions related specifically to this business. As a result of these developments, both calendar and accident year loss reserve development have trended adversely, particularly for the aforementioned accident years. Excluding the impact of the commutations, prior year reserve development would have been relatively flat if not favorable, as has historically been the case. The group's lead company, HC, has borne the brunt of the adverse reserve development, specifically related to its run-off accident and health reinsurance business. The exit from the workers' compensation line of business several years ago, with the exception of minimum premium workers' compensation business, has also led to recorded deficiencies, although the magnitude of these deficiencies is no longer material to overall reserve development. The lines of business reporting more favorable loss reserve development include property, aviation and marine lines of business. Absent the negative impact of additional reinsurance commutations, A.M. Best expects the group's reserve development pattern to continue being more reflective of historical norms over the near term.

LOSS & ALAE RESERVE DEVELOPMENT: CALENDAR YEAR ($000)

Calendar Year	Original Loss Reserves	Developed Reserves Thru 2007	Develop. to Orig.(%)	Develop. to PHS (%)	Develop. to NPE (%)	Unpaid Reserves @12/2007	Unpaid Resrv. to Dev.(%)
2002	183,460	373,687	103.7	47.5	206.6	370,910	99.3
2003	364,934	476,479	30.6	27.2	150.3	434,241	91.1
2004	586,434	606,132	3.4	3.3	144.2	520,496	85.9
2005	943,965	919,976	-2.5	-3.0	189.5	725,614	78.9
2006	1,151,441	1,123,891	-2.4	-2.9	226.1	920,937	81.9
2007	1,148,496	1,148,496	…	…	253.3	1,148,496	100.0

LOSS & ALAE RESERVE DEVELOPMENT: ACCIDENT YEAR ($000)

Accident Year	Original Loss Reserves	Developed Reserves Thru 2007	Develop. to Orig.(%)	Unpaid Reserves @12/2007	Acc Yr. Loss Ratio	Acc Yr. Comb Ratio
2002	76,026	99,627	31.0	58,956	72.1	101.0
2003	158,816	120,523	-24.1	63,331	46.3	72.3
2004	214,291	159,261	-25.7	86,255	48.3	75.8
2005	309,469	290,005	-6.3	205,118	67.2	97.3
2006	252,220	244,216	-3.2	195,323	55.3	81.4
2007	227,559	227,559	…	227,559	56.7	84.8

Reinsurance Utilization: Maintaining sufficient reinsurance to support the catastrophe portion of its portfolio, as well as limiting its exposure in any one class of business, is an integral part of the group's business strategy. Various domestic and foreign reinsurers are utilized in order to limit the group's credit risk to any particular reinsurer. In addition, management has positioned the group to be able to increase the utilization of reinsurance as market conditions warrant, while maintaining a solid balance sheet to support increased retention of premium when reinsurance capacity lessens. A specific reinsurance program is structured for each line of business. Since the beginning of 2002, the group has significantly reduced its ceded business, going from ceding almost two-thirds of its gross book of business, to approximately 30%. This strategic change has been undertaken to increase retentions, capitalize on the rising rates and improved market conditions, and manage reinsurance costs.

Despite the reduction, the utilization of reinsurance to mitigate the group's exposure to any one event leaves it exposed to the impact of changes in the reinsurance sector, including but not limited to pricing behavior, credit risk and dispute risk. As such, management remains highly attuned to activity in the reinsurance market sector seeking to ensure that the group remains aligned with financially strong reinsurance partners. The focus on maintaining solid partnerships has led to the commutation of recoverables when circumstances determined it to be the best strategic option.

The group's total reinsurance recoverables, specifically those related to unpaid and incurred but not reported (IBNR) losses, have increased historically because of the growth in gross writings and the effect of catastrophe losses, principally hurricanes. A.M. Best anticipates that the level of reinsurance recoverables will likely continue to decline modestly as reinsurance related to catastrophes are collected.

CEDED REINSURANCE ANALYSIS ($000)

	Company				Industry Composite		
Year	Ceded Reins Total	Business Retention (%)	Rein Rec to PHS (%)	Ceded Reins to PHS (%)	Business Retention (%)	Rein Rec to PHS (%)	Ceded Reins to PHS(%)
2003	1,356,461	46.4	212.2	331.3	39.0	113.4	168.6
2004	1,515,672	50.8	175.2	250.8	42.3	110.1	151.9
2005	1,546,438	61.0	149.2	190.3	42.1	116.1	152.2
2006	1,198,756	66.2	99.3	125.9	45.9	92.1	124.1
2007	1,033,688	64.5	63.0	82.0	45.2	71.0	95.7

2007 REINSURANCE RECOVERABLES ($000)

	Paid & Unpaid Losses	IBNR	Unearned Premiums	Other Recov*	Total Reins Recov
US Affiliates	-31	…	37	…	6
Foreign Affiliates	1,485	1	19,501	-3,657	17,330
US Insurers	128,340	123,089	59,170	-2,459	308,140
Pools/Associations	48	…	…	-4	44
Other Non-US	275,128	144,359	61,898	-12,917	468,468
Total (ex US Affils)	405,001	267,449	140,569	-19,037	793,982
Grand Total	404,970	267,449	140,606	-19,037	793,988

* Includes Commissions less Funds Withheld

INVESTMENT LEVERAGE ANALYSIS (% OF PHS)

	Company						Industry Composite	
Year	Class 3-6 Bonds	Real Estate/ Mtg.	Other Invested Assets	Common Stocks	Non-Affl Inv. Lev.	Affil Inv.	Class 3-6 Bonds	Common Stocks
2003	…	…	3.1	1.0	4.1	61.3	1.3	18.1
2004	…	…	3.1	-4.6	-1.5	49.0	1.6	18.2
2005	…	…	9.6	4.5	14.1	47.4	1.7	16.6
2006	0.3	…	12.3	6.1	18.8	53.0	0.9	17.8
2007	0.2	…	10.6	3.9	14.7	51.6	0.9	16.4

LIQUIDITY

The following text is derived from the report of Houston Casualty Group.

Overall Liquidity: The group maintains a sound liquidity position as evidenced by current and overall liquidity ratios that are on par with industry composite averages. Increased emphasis on shorter-term bonds in the last few years has helped maintain the sound liquidity, as has the positive impact of reinsurance commutations on cash holdings. The level of invested assets has increased by almost four times since year-end 2001, thereby offsetting similar growth in total liabilities stemming from higher loss reserves and a larger unearned premium balance. Operating cash flow, driven by increased premiums collected, has risen significantly in recent years. Historically, the group's adequate liquidity position has been derived from consistent operating cash flow and contributed capital from the parent holding company with solid investment income also contributing.

In October 2007, parent HCC Insurance Holdings, Inc., increased its existing $300 million bank credit facility to $575 million. The facility expires in December 2011. There was $200 million outstanding on this facility as of December 31, 2007. In September of 2007, HCC announced its intent to redeem all of its outstanding 2.00% convertible exchange notes in October, increasing the $40.0 million balance outstanding on the bank facility to $210.0 million to fund the principal payments on the notes. Previously, in late May of 2006, the parent company filed for a new $1 billion universal shelf registration, to replace the $750 million shelf previously in place. This shelf allows HCC to issue debt, stock, or any other subordinated debt type of security and helps provide the group with great financial flexibility.

LIQUIDITY ANALYSIS

	Company				Industry Composite			
Year	Quick Liq (%)	Current Liq (%)	Overall Liq (%)	Gross Agents Bal to PHS(%)	Quick Liq (%)	Current Liq (%)	Overall Liq (%)	Gros Agents Ba to PHS(%
2003	29.2	88.7	163.8	38.6	34.0	118.4	154.1	14.
2004	34.9	104.3	166.1	26.9	34.8	128.2	154.4	13.
2005	36.7	114.9	164.9	18.9	31.1	130.7	154.9	13.
2006	23.1	107.4	165.2	12.6	35.1	140.3	158.3	12.
2007	25.2	124.9	185.1	7.8	31.6	146.2	165.1	10.
09/2007	XX	122.5	178.1	9.4	XX	XX	XX	X
09/2008	XX	129.4	194.6	9.6	XX	XX	XX	X

CASH FLOW ANALYSIS ($000)

		Company				Industry Composite	
Year	Underw Cash Flow	Oper Cash Flow	Net Cash Flow	Underw Cash Flow (%)	Oper Cash Flow (%)	Underw Cash Flow (%)	Oper Cash Flow (%)
2003	262,627	290,565	86,909	292.1	289.4	220.3	204.6
2004	248,162	275,093	153,745	217.8	224.5	198.3	196.7
2005	355,168	373,978	46,536	341.9	317.3	148.8	157.5
2006	271,444	273,644	-161,832	230.5	206.9	153.8	156.9
2007	86,579	138,229	-7,372	124.2	134.0	141.3	140.9
09/2007	93,814	142,214	-28,262	137.8	149.5	XX	XX
09/2008	81,816	121,314	15,484	138.7	151.4	XX	XX

HISTORY

The company was incorporated under the laws of Texas on December 9, 1980, as International Indemnity Company of Texas and began business on June 18, 1981. The name was changed to Houston Casualty Company on May 26, 1983.

Capital paid-up at year-end was $5,000,000 consisting of 5,000,000 shares of common stock at a par value of $1 per share. Authorized capital stock at year end was 10,000,000 shares.

MANAGEMENT

The company is ultimately wholly owned by HCC Insurance Holdings, Inc., a publicly held insurance and insurance-related services holding company traded on the NYSE under the symbol HCC. Administration of the company's affairs is under the direction of Michael J. Schell, Chief Executive Officer and Executive Vice President of HCC Insurance Holdings, Inc.

Officers: Chief Executive Officers, Charles Manchester (London Branch), Michael J. Schell; Presidents, Barry Cook (London Branch), Thomas G. Kaiser; Chief Operating Officer, Nick Huttono-Penman (London Branch); Chief Underwriting Officer, Michael Onslow (London Branch); Executive Vice Presidents, Edward H. Ellis, Jr., John N. Molbeck, Jr.; Senior Vice President and Actuary, Annette J. Goodreau; Senior Vice Presidents, Mark A. Buechler, Michael J. Donovan, Brian E. Duffy, Duane R. Dyckman, Brendan Merriman (London Branch), Carl R. Nederman, Mark P. Reynolds, Mark P. Rickert, Randy D. Rinicella; Vice President and Chief Financial Officer, Stephen P. MacDonough; Vice Presidents and Treasurers, Rowland Hughes (London Branch), Hamendra P. Ojha; Vice Presidents, Christopher D. Bonnett, Sharon L. Brock, Jackie S. Kellems, Christopher M. Lewis, Joycelyn M. Ray, Deborah L. Riffe, Christopher S. Throckmorton (Chief Pricing Actuary); Secretary, James L. Simmons; Controller, Chris Tlucek.

Directors: Edward H. Ellis, Jr., Stephen P. MacDonough, John N. Molbeck, Jr., Hamendra P. Ojha, Pamela J. Penny, Randy D. Rinicella, Michael J. Schell.

REGULATORY

An examination of the financial condition was made as of December 31, 2003 by the Insurance Departments of Delaware and Texas. The 2007 annual independent audit of the company was conducted by PricewaterhouseCoopers, LLP. The annual statement of actuarial opinion is provided by John F. Gibson, FCAS, MAAA, PricewaterhouseCoopers, LLP.

TERRITORY

The company is licensed in Texas. It also operates on a surplus lines or non-admitted basis in the District of Columbia, American Samoa, Guam, Puerto Rico, U.S. Virgin Islands, AL, AK, AZ, AR, CA, CO, CT, DE, FL, GA, HI, ID, IL, IN, IA, KS, KY, LA, ME, MD, MA, MI, MN, MS, MO, MT, NE, NV, NH, NJ, NM, NY, NC, ND, OH, OK, OR, PA, RI, SC, SD, TN, UT, VT, VA, WA, WV, WI and WY.

REINSURANCE PROGRAMS

The following text is derived from the report of Houston Casualty Group.

Reinsurance is maintained on a quota share and excess of loss basis with a separate program maintained for each line of business. Catastrophe coverage is purchased for property, marine, and energy business that is exposed to natural disasters and aviation for ground accumulation. Facultative reinsurance is also purchased when deemed appropriate.

BALANCE SHEET ($000)

ADMITTED ASSETS	12/31/2007	12/31/2006	2007 %	2006 %
Bonds	1,501,491	1,236,915	54.0	49.1
Preferred stock	…	2,016	…	0.1
Common stock	49,091	58,453	1.8	2.3
Cash & short-term invest	172,057	179,430	6.2	7.1
Other non-affil inv asset	133,644	117,367	4.8	4.7
Investments in affiliates	641,154	494,553	23.0	19.6
Real estate, offices	9,601	9,589	0.3	0.4
Total invested assets	2,507,038	2,098,324	90.1	83.3
Premium balances	157,288	174,985	5.7	6.9
Accrued interest	17,580	37,354	0.6	1.5
All other assets	100,091	209,755	3.6	8.3
Total assets	2,781,997	2,520,418	100.0	100.0
LIABILITIES & SURPLUS	12/31/2007	12/31/2006	2007 %	2006 %
Loss & LAE reserves	1,155,555	1,157,487	41.5	45.9
Unearned premiums	225,190	253,798	8.1	10.1
Conditional reserve funds	19,000	42,665	0.7	1.7
All other liabilities	122,044	114,385	4.4	4.5
Total liabilities	1,521,789	1,568,335	54.7	62.2
Capital & assigned surplus	573,179	567,352	20.6	22.5
Unassigned surplus	687,028	384,731	24.7	15.3
Total policyholders' surplus	1,260,208	952,083	45.3	37.8
Total liabilities & surplus	2,781,997	2,520,418	100.0	100.0

SUMMARY OF 2007 OPERATIONS ($000)

STATEMENT OF INCOME	12/31/2007
Premiums earned	453,470
Losses incurred	196,928
LAE incurred	39,053
Undrw expenses incurred	119,360
Net underwriting income	98,128
Net investment income	73,895
Other income/expense	176
Pre-tax oper income	172,199
Realized capital gains	12,319
Income taxes incurred	47,912
Net income	136,605

FUNDS PROVIDED FROM OPERATIONS	12/31/2007
Premiums collected	444,230
Benefit & loss related pmts	210,234
LAE & undrw expenses paid	147,417
Undrw cash flow	86,579
Investment income	99,870
Other income/expense	176
Pre-tax cash operations	186,625
Income taxes pd (recov)	48,397
Net oper cash flow	138,229

INTERIM BALANCE SHEET ($000)

ADMITTED ASSETS	03/31/2008	06/30/2008	09/30/2008
Cash & short term invest	136,493	149,385	187,542
Bonds	1,578,928	1,650,508	1,640,683
Preferred stock	5,121	4,877	…
Common stock	716,967	711,623	720,937
Other investments	147,439	136,984	123,278
Total investments	2,584,947	2,653,376	2,672,440
Premium balances	152,514	173,542	175,807
Reinsurance funds	49,162	41,540	47,766
Accrued interest	18,202	19,228	18,918
All other assets	39,980	38,185	37,332
Total assets	2,844,804	2,925,871	2,952,263

LIABILITIES & SURPLUS	03/31/2008	06/30/2008	09/30/2008
Loss & LAE reserves	1,169,232	1,161,888	1,157,310
Unearned premiums	214,796	231,191	214,427
Conditional reserve funds	16,993	19,787	42,341
All other liabilities	126,619	136,978	145,365
Total liabilities	1,527,640	1,549,844	1,559,444
Capital & assigned surp	573,251	573,546	574,000
Unassigned surplus	743,914	802,482	818,820
Policyholders' surplus	1,317,165	1,376,028	1,392,820
Total liabilities & surplus	2,844,804	2,925,871	2,952,263

INTERIM INCOME STATEMENT ($000)

	Period Ended 09/30/2008	Period Ended 09/30/2007	Increase/ Decrease
Premiums earned	303,716	340,108	-36,391
Losses incurred	120,007	152,135	-32,128
LAE incurred	28,799	24,947	3,852
Underwriters expenses incurred	74,558	80,635	-6,077
Net underwriting income	80,352	82,391	-2,039
Net investment income	59,102	63,836	-4,734
Other income/expenses	360	62	299
Pre-tax operating income	139,814	146,288	-6,474
Realized capital gains	-6,053	4,612	-10,664
Income taxes incurred	39,025	40,576	-1,551
Net income	94,737	110,324	-15,587

INTERIM CASH FLOW ($000)

	Period Ended 09/30/2008	Period Ended 09/30/2007	Increase/ Decrease
Premiums collected	293,365	341,872	-48,507
Benefit & loss related pmts	109,692	146,724	-37,032
Undrw expenses paid	101,857	101,334	523
Underwriting cash flow	81,816	93,814	-11,997
Investment income	63,537	87,754	-24,217
Other income/expense	360	62	299
Pre-tax cash operations	145,714	181,630	-35,916
Income taxes pd (recov)	24,400	39,416	-15,016
Net oper cash flow	121,314	142,214	-20,900