HCC INSURANCE HOLDINGS INC/DE/
Form 10-K
March 01, 2010

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

# Form 10-K

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|---|---|
| **þ** | **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.** |
| **o** | **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.** |
| | **For the fiscal year ended December 31, 2009** |

**Commission file number 001-13790**

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

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

**(713) 690-7300**

**(Registrant s telephone number, including area code)**

**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 o

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 o   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 o

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).  o Yes   o 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.  o

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 o   Non-accelerated filer o   Smaller reporting company o

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

The aggregate market value on June 30, 2009 (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 $2.7 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 19, 2010 was 114.6 million.

**DOCUMENTS INCORPORATED BY REFERENCE:**

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

**HCC INSURANCE HOLDINGS, INC.**

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**FORWARD-LOOKING STATEMENTS**

*This 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. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as 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. Also, when we use words such as anticipate, believe, estimate, expect, intend, plan, probably o expressions, we are making forward-looking statements.*

*Many risks and uncertainties may impact 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 the credit market downturn and subprime market exposures,*

*the effects of emerging claim and coverage issues,*

*the effects of extensive governmental regulation of the insurance industry,*

*potential credit risk with brokers,*

*the effects of industry consolidation,*

*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,*

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

*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,*

*potential changes to the country s health care delivery system,*

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- *the effect, if any, of climate change, on the risks we insure,*
- *change of control, and*
- *difficulties with outsourcing relationships.*

*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, also the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements that are included in this Report, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.*

*Our forward-looking statements speak only 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.*

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## PART I

### Item 1. *Business*

### Business Overview

HCC Insurance Holdings, Inc. is a Delaware corporation, which was formed in 1991. Its predecessor corporation was formed in 1974. Our principal executive offices are located at 13403 Northwest Freeway, Houston, Texas 77040, and our telephone number is (713) 690-7300. 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 Securities and Exchange Commission (SEC) as soon as reasonably practicable after we have filed or furnished such materials with the SEC.

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.

We provide specialized property and casualty, surety, and group life, accident and health insurance coverages and agency services to commercial customers and individuals. We concentrate our activities in selected, narrowly defined, specialty lines of business. We operate primarily in the United States, the United Kingdom, Spain and Ireland. Some of our operations have a broader international scope. We underwrite on both a direct basis, where we insure a risk in exchange for a premium, and on a reinsurance (assumed) basis, where we insure all or a portion of another, or ceding, insurance company s risk in exchange for all or a portion of the ceding insurance company s premium for the risk. We market our products both directly to customers and through a network of independent and affiliated brokers, producers, agents and third party administrators.

Since our founding, we have been consistently profitable, generally reporting annual increases in total revenue and shareholders equity. During the period 2005 through 2009, we had an average statutory combined ratio of 86.5% versus the less favorable 98.7% (source: A.M. Best Company, Inc.) recorded by the U.S. property and casualty insurance industry overall. During the period 2005 through 2009, our gross written premium increased from $2.0 billion to $2.6 billion, an increase of 26%, while net written premium increased 36% from $1.5 billion to $2.0 billion. During this period, our revenue increased from $1.6 billion to $2.4 billion, an increase of 45%. During the period December 31, 2005 through December 31, 2009, our shareholders equity increased 78% from $1.7 billion to $3.0 billion and our assets increased 26% from $7.0 billion to $8.8 billion.

Our insurance companies and Lloyd s of London syndicates are risk-bearing and focus their underwriting activities on providing insurance and/or reinsurance in the following lines of business:

- Diversified financial products
- Group life, accident and health
- Aviation
- London market account

Other specialty lines

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Our insurance companies have strong financial strength ratings. Standard & Poor s Corporation, Fitch Ratings, Moody s Investors Service, Inc. and A.M. Best Company, Inc. are internationally recognized independent rating agencies. These financial strength ratings are intended to provide an independent opinion of an insurer s ability to meet its obligations to policyholders and are not evaluations directed at investors. Our financial strength ratings as of December 31, 2009 were as follows:

| Companies | Standard & Poor s | Fitch Ratings | Moody s | A.M. Best |
|---|---|---|---|---|
| Domestic insurance companies | | | | |
| American Contractors Indemnity Company | AA | AA | | A |
| Avemco Insurance Company | AA | AA | | A+ |
| HCC Life Insurance Company | AA | AA | A1 | A+ |
| HCC Specialty Insurance Company | AA | AA | | A+ |
| Houston Casualty Company | AA | AA | A1 | A+ |
| Perico Life Insurance Company | | AA | | A |
| U.S. Specialty Insurance Company | AA | AA | A1 | A+ |
| United States Surety Company | AA | AA | | A |
| International insurance companies | | | | |
| HCC International Insurance Company | AA | | | |
| HCC Europe | AA | | | |
| HCC Reinsurance Company | AA | | | |

Standard & Poor s AA (Very Strong) rating is the 3rd highest of their 23 ratings. Fitch Ratings AA (Very Strong) is the 3rd highest of their 21 ratings. Moody s A1 (Good Security) is the 5th highest of their 21 ratings. A.M. Best s A+ (Superior) is the 2nd highest and A (Excellent) is the 3rd highest of their 16 ratings.

Lloyd s of London, the insurance market through which our two Lloyd s syndicates operate, is composed of numerous managing agents that run independent underwriting syndicates. Participants in each syndicate provide a specified amount of capital to support the syndicate s business. If needed, any shortfall in a syndicate s capital is supported by Lloyd s Central Fund. Lloyd s of London is rated A+ by Fitch Ratings and Standard & Poor s and A by A.M. Best.

Our underwriting agencies underwrite on behalf of our insurance companies and, in certain situations, for other unaffiliated insurance companies. They receive fees for these services and do not bear any of the insurance risk of the companies for which they underwrite. Our underwriting agencies generate the majority of their revenue based on fee income. The agencies specialize in the following types of business: contingency (including contest indemnification, event cancellation and weather coverages); directors and officers liability; individual disability (for athletes and other high profile individuals); kidnap and ransom; employment practices liability; errors and omissions liability (known as professional indemnity outside the United States); public entity; various financial products; short-term medical; fidelity, difference in conditions (earthquake) and other specialty business. Our principal underwriting agencies are G.B. Kenrick & Associates, HCC Global Financial Products, HCC Indemnity Guaranty Agency, HCC Specialty Underwriters, HCC Medical Insurance Services, LLC, Professional Indemnity Agency, RA&MCO Insurance Services and HCC Underwriting Agency, Ltd. (UK).

## Our Strategy

Our business philosophy is to maximize underwriting profits while limiting risk in order to preserve shareholders equity and maximize earnings. We concentrate our insurance writings in selected specialty lines of business in which we believe we can achieve an underwriting profit. We also rely on our experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to achieve our strategic

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objectives. We market our insurance products both directly to customers and through affiliated and independent brokers, agents, producers and third party administrators.

The property and casualty insurance industry and individual lines of business within the industry are cyclical. There are times, particularly when there is excess capital in the industry or underwriting results have been good, in which a large number of companies offer insurance on certain lines of business, causing premium rates and premiums written by companies to trend downward (a soft market). During other times, insurance companies limit their writings in certain lines of business due to lack of capital or following periods of excessive losses. This results in an increase in premium rates and premiums for those companies that continue to write insurance in those lines of business (a hard market).

In our insurance operations, we believe our operational flexibility, which permits us to shift the focus of our insurance underwriting activity among our various lines of business, allows us to implement a strategy of emphasizing more profitable lines of business during periods of increased premium rates and de-emphasizing less profitable lines of business during periods of increased competition.

Following a period in which premium rates rose substantially, premium rates in several of our lines of business became more competitive during the past six years. The rate decreases were more gradual than the prior rate increases; thus, our underwriting activities remain profitable. During the past several years, we expanded our underwriting activities and increased our retentions 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 have resulted in additional underwriting profits, investment income and net earnings.

Through reinsurance, our insurance companies and syndicates may transfer or cede all or part of the risk we have underwritten to a reinsurance company in exchange for all or part of the premium we receive in connection with the risk. We purchase reinsurance to limit the net loss to our insurance companies and syndicates from both individual and catastrophic risks. The amount of reinsurance we purchase varies depending on, among other things, the particular risks inherent in the policies underwritten; the pricing, coverage and terms of the reinsurance; and the competitive conditions within the relevant line 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 profits. In this regard, we may purchase less proportional or quota share reinsurance, thus accepting more of the risk but possibly replacing it with 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 in which we believe there has been a favorable loss history, our policy limits are relatively low and we determine there is a low likelihood of catastrophe exposure.

We also acquire businesses and hire new underwriting teams that we believe present opportunities for future profits and enhancement of our business. We expect to continue to acquire complementary businesses and add underwriting teams. We believe that we can enhance acquired businesses and platforms for new underwriting teams with our infrastructure, ratings and financial strength.

Our business plan is shaped by our underlying business philosophy, which is to maximize underwriting profit and net earnings while limiting risk and preserving and achieving long-term growth of shareholders equity. As a result, our primary objective is to increase net earnings rather than market share or gross written premium.

In our ongoing operations, we will continue to:

- emphasize the underwriting of lines of business in which there is an anticipation of underwriting profits based on various factors, including premium rates, the availability and cost of reinsurance, policy terms and conditions, and market conditions,
- maintain a highly non-correlated portfolio of business,

limit our insurance companies aggregate net loss exposure from a catastrophic loss through the control of aggregate limits written, the use of reinsurance for those lines of business exposed to such losses and diversification into lines of business not exposed to such losses, and

consider the potential acquisition of specialty insurance operations and the hiring of underwriting teams.

## Industry Segment and Geographic Information

Financial information concerning our operations by industry segment and geographic data is included in the Consolidated Financial Statements and Notes thereto.

## Acquisitions

We have made a series of acquisitions that have furthered our overall business strategy. Our major transactions during the last three years are described below:

On January 2, 2008, we acquired HCC Medical Insurance Services, LLC (formerly MultiNational Underwriters, LLC), an underwriting agency located in Indianapolis, Indiana, for cash consideration of $42.7 million and possible additional cash consideration depending upon future underwriting profit levels. This agency writes domestic and international short-term medical insurance through Syndicate 4141 at Lloyd s of London.

In the fourth quarter of 2008, we acquired four underwriting agencies for total consideration of $29.9 million. On October 1, 2008, we acquired the Criminal Justice division of U.S. Risk Insurance Brokers. Rebranded Pinnacle Underwriting Partners, this newly established underwriting agency, located in Scottsdale, Arizona, serves the private detention and security industry. On November 1, 2008, we acquired Cox Insurance Group, a medical stop-loss managing general underwriter covering the midwestern United States. On December 1, 2008, we acquired Arrowhead Public Risk, a division of Arrowhead General Insurance Agency, Inc., a managing general agency based in Richmond, Virginia, specializing in risk management for the public entity sector. On December 31, 2008, we acquired VMGU Insurance Agency, a leading underwriter of the lumber, building materials, forest products and woodworking industries, based in Waltham, Massachusetts.

On February 27, 2009, we acquired Surety Company of the Pacific, a leading California writer of license and permit bonds in the western United States, headquartered in Encino, California.

We continue to evaluate acquisition opportunities, and we may complete additional acquisitions during 2010. Any future acquisitions will be designed to expand and strengthen our existing lines of business or to provide access to additional specialty sectors, which we expect to contribute to our overall growth.

## Insurance Company Operations

### *Lines of Business*

We underwrite business produced through affiliated underwriting agencies, through independent brokers, producers and third party administrators, and by direct marketing efforts. We also write facultative or individual account reinsurance, as well as some treaty reinsurance business. This table shows our insurance

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companies total premium written, otherwise known as gross written premium, by line of business and the percentage of each line to total gross written premium (dollars in thousands).

| | 2009 | | 2008 | | 2007 | |
|---|---|---|---|---|---|---|
| Diversified financial products | $ 1,147,913 | 45% | $ 1,051,722 | 42% | $ 963,355 | 39% |
| Group life, accident and health | 846,041 | 33 | 829,903 | 33 | 798,684 | 33 |
| Aviation | 176,073 | 7 | 185,786 | 8 | 195,809 | 8 |
| London market account | 186,603 | 7 | 175,561 | 7 | 213,716 | 9 |
| Other specialty lines | 203,009 | 8 | 251,021 | 10 | 280,040 | 11 |
| Discontinued lines of business | 152 | | 4,770 | | (425) | |
| **Total gross written premium** | $ 2,559,791 | 100% | $ 2,498,763 | 100% | $ 2,451,179 | 100% |

This table shows our insurance companies actual premium retained, otherwise known as net written premium, by line of business and the percentage of each line to total net written premium (dollars in thousands).

| | 2009 | | 2008 | | 2007 | |
|---|---|---|---|---|---|---|
| Diversified financial products | $ 915,595 | 45% | $ 872,007 | 42% | $ 771,648 | 39% |
| Group life, accident and health | 796,778 | 39 | 789,479 | 38 | 759,207 | 38 |
| Aviation | 124,336 | 6 | 136,019 | 7 | 145,761 | 7 |
| London market account | 102,407 | 5 | 107,234 | 5 | 118,241 | 6 |
| Other specialty lines | 107,047 | 5 | 151,120 | 8 | 191,151 | 10 |
| Discontinued lines of business | 126 | | 4,759 | | (399) | |
| **Total net written premium** | $ 2,046,289 | 100% | $ 2,060,618 | 100% | $ 1,985,609 | 100% |

This table shows our insurance companies net written premium as a percentage of gross written premium, otherwise referred to as percentage retained, for our lines of business.

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Diversified financial products | 80% | 83% | 80% |
| Group life, accident and health | 94 | 95 | 95 |
| Aviation | 71 | 73 | 74 |
| London market account | 55 | 61 | 55 |
| Other specialty lines | 53 | 60 | 68 |
| **Consolidated percentage retained** | 80% | 82% | 81% |

***Diversified Financial Products***

We underwrite a variety of financial insurance risks in our diversified financial products line of business. These risks include:

- directors and officers liability
- employment practices liability
- errors and omissions liability
- surety and credit
- fidelity
- various financial products

We began to underwrite this line of business through a predecessor company in 1977. Our insurance companies started participating in this business in 2001. We have substantially increased our level of business through the acquisition of a number of agencies and insurance companies that operate in this line of business, both domestically and internationally. Each of the acquired entities has significant experience in its respective specialty within this line of business. We have also formed entities developed around teams of experienced underwriters that offer these products.

In 2002 and 2003, following several years of insurance industry losses, significant rate increases were experienced throughout our diversified financial products line of business, particularly directors and officers liability, which we began underwriting in 2002. We benefited greatly from these improved conditions despite the fact that we had not been involved in the past losses. Rates softened between 2004 and 2009 for some of the products in this line, but some of the products had rate increases in 2008 and 2009. Our underwriting margins remain profitable. There is also considerable investment income derived from diversified financial products due to the extended periods involved in any claims resolution. Although individual losses in the directors and officers public company liability business and portions of our U.S. errors and omissions business may have potential severity, the remainder of the diversified financial products business is less volatile with relatively low limits.

***Group Life, Accident and Health***

We write medical stop-loss business through HCC Life Insurance Company and Perico Life Insurance Company. Our medical stop-loss insurance provides coverages to companies, associations and public entities that elect to self-insure their employees medical coverage for losses within specified levels, allowing them to manage the risk of excessive health insurance exposure by limiting aggregate and specific losses to a predetermined amount. We first began writing this business through a predecessor company in 1980. Our insurance companies started participating in this business in 1997. This line of business has grown both organically and through acquisitions. We are considered a market leader in medical stop-loss insurance. We also underwrite a small program of group life insurance, offered to our insureds as a complement to our medical stop-loss products.

Premium rates for medical stop-loss business rose substantially beginning in 2000 and, although competition has increased in recent years, underwriting results have remained profitable. Premium rate increases together with deductible increases are still adequate to cover medical cost trends. Medical stop-loss business has relatively low limits, a low level of catastrophe exposure, a generally predictable result and a short time span between the writing of premium, the reporting of claims and the payment of claims. We currently buy no reinsurance for this line of business.

Our risk management business is composed of HMO and medical excess risks. This business has relatively low limits and a low level of catastrophe exposure. The business is competitive, but remains profitable.

We began writing occupational accident insurance in 1996. This business is currently written through U.S. Specialty Insurance Company. These products have relatively low limits, a relatively low level of catastrophe exposure and a generally predictable result.

With the acquisition of HCC Medical Insurance Services, LLC, we began writing short-term domestic and international medical insurance that covers individuals or groups when there is a lapse in coverage or when traveling internationally. This business has relatively low limits and the term is generally of short duration. This business is primarily produced on an internet platform.

***Aviation***

We are a market leader in the general aviation insurance industry insuring aviation risks, both domestically and internationally. Types of aviation business we insure include:

- antique and vintage military aircraft
- cargo operators
- commuter airlines

corporate aircraft

fixed base operations

military law enforcement aircraft

private aircraft owners

rotor wing aircraft

We offer coverages that include hulls, engines, avionics and other systems, liabilities, cargo and other ancillary coverages. We generally do not insure major airlines and major manufacturers. Insurance claims related to general aviation business tend to be seasonal, with the majority of the claims being incurred during warm weather months.

We are one of the largest writers of personal aircraft insurance in the United States. Our aviation gross premium has remained relatively stable since 1998, but it has decreased slightly in 2007 through 2009 due to competition and decreasing rates, principally in the domestic business. We have generally increased our retentions since 1998 as this business is predominantly written with small limits and has generally predictable results.

***London Market Account***

Our London market account business consists of marine, energy, property, and accident and health business and has been primarily underwritten by Houston Casualty Company s London branch office. During 2006, we began to utilize HCC International Insurance Company to underwrite the non-U.S. based risks for this line of business. Beginning in 2009, we have utilized our Lloyd s of London Syndicate 4141 to write certain of this business. We expect to increase the use of that platform in the future.

This line includes a significant portion of our catastrophe exposures. We have underwritten these risks for more than 15 years, increasing or decreasing our premium volume depending on market conditions, which can be very volatile in this line. The following table presents the details of net premium written within the London market account line of business (in thousands).

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Marine | $ 14,373 | $ 14,413 | $ 30,685 |
| Energy | 43,807 | 44,554 | 45,962 |
| Property | 22,941 | 28,827 | 19,856 |
| Accident and health | 21,286 | 19,440 | 21,738 |
| **Total London market account net written premium** | $ 102,407 | $ 107,234 | $ 118,241 |

*Marine*

We underwrite marine risks for ocean-going vessels including hull, protection and indemnity, liabilities and cargo. We have underwritten marine risks since 1984 in varying amounts depending on market conditions.

*Energy*

In our energy business, we underwrite physical damage, business interruption and other ancillary coverages. We have been underwriting both onshore and offshore energy risks since 1988. This business includes but is not limited to:

- drilling rigs
- gas production and gathering platforms
- natural gas facilities
- petrochemical plants

pipelines

refineries

The market was soft for this business and rates were at relatively low levels from the late 1990 s through 2004. During this period, we underwrote the business selectively and also bought large amounts of facultative reinsurance to protect our exposure to risk. Hurricane Ivan produced large energy losses to the industry in 2004 and both Hurricane Katrina and Rita produced large losses to the industry in 2005. A very hard market developed for underwriting year 2006, with large rate increases and restrictive policy terms, including imposition of aggregate named windstorm limits in vulnerable areas, rather than just occurrence limits. We had ample capacity to increase our business in this line, and did so due to the attractive prices and terms in 2006 for taking the additional underwriting risk. After a very profitable 2006, prices weakened in 2007 and 2008, but at levels we still considered reasonable, and we generally maintained our book at similar exposure levels as in 2006. In 2008, Hurricane Ike produced large losses to the industry, which resulted in another upswing in pricing in 2009. Although we had growth in premium due to the rising rates in 2009, the growth was limited due to policyholders choosing to self insure portions of their insurance programs that they formerly insured. During the large catastrophe period of 2004 2008, we were able to generate profits from the business due to the individual hurricane losses remaining within our expectations and within the excess of loss reinsurance purchased by us to cover such events.

*Property*

We underwrite property business specializing in risks of large, often multinational, corporations, covering a variety of commercial properties, which include but are not limited to:

| | |
|---|---|
| factories | office buildings |
| hotels | retail locations |
| industrial plants | utilities |

We have written property business since 1986, including business interruption, physical damage and catastrophe risks, such as flood and earthquake. Rates increased significantly following September 11, 2001, but trended downward by 2005 despite the hurricane activity in 2004. Massive losses from hurricanes in 2005 resulted in substantial rate increases, but due to over capacity, policy conditions have remained unchanged, unlike energy risks. Accordingly, we substantially reduced our involvement in policies with coastal exposures in the Florida and U.S. Gulf Coast regions. We continue to buy substantial catastrophe reinsurance, unlike many industry participants, which was shown to be adequate during 2004 and 2005 when large amounts of industry capital were lost. While the hurricane activity seriously affected our earnings in the third quarters of 2004 and 2005, we still were able to produce record annual earnings in those years. This business was profitable in 2006, 2007 and 2009 as there were no significant catastrophe losses, and in 2008 despite the losses from two hurricanes.

In the fourth quarter of 2009, we added an underwriting team to write property treaty reinsurance.

*Accident and Health*

We began writing London market accident and health risks in 1996, including trip accident, medical and disability. Due to past experience and other market factors, we significantly decreased premiums starting in 2004, and our business is now much more stable and profitable.

Our London market account is reinsured principally on an excess of loss basis. We closely monitor catastrophe exposure, most of which occurs in our London market account, and purchase reinsurance to limit our net exposure to a level such that any one loss is not expected to impact our capital or exceed our net earnings in the affected quarter. Previous catastrophe losses, net of reinsurance, from Hurricane Andrew in 1992, the Northridge Earthquake in 1994, the terrorist attacks on September 11, 2001, and the hurricanes of 2004, 2005 and 2008 did not exceed our net earnings in the quarter when each occurred.

**Other Specialty Lines**

In addition to the above, we underwrite various other specialty lines of business, including different types of property and liability business, such as event cancellation, contingency, public entity and U.K. liability. We had an assumed quota share contract for surplus lines business that expired in March 2008. Individual premiums by type of business are not material to the Other Specialty Lines line of business.

**Insurance Companies and Lloyd s of London Syndicates**

***Houston Casualty Company***

Houston Casualty Company is our largest insurance company subsidiary. It is domiciled in Texas and insures risks worldwide. Houston Casualty Company underwrites business produced by independent agents and brokers, affiliated underwriting agencies, reinsurance brokers, and other insurance and reinsurance companies. Houston Casualty Company writes diversified financial products, aviation, London market account

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and other specialty lines of business. Houston Casualty Company s 2009 gross written premium, including Houston Casualty Company-London, its United Kingdom branch, was $539.4 million.

***Houston Casualty Company-London***

Houston Casualty Company operates a branch office in London, England, in order to more closely align its underwriting operations with the London market, a historical focal point for some of the business that it underwrites. In 2006, we focused the underwriting activities of Houston Casualty Company-London s office on risks based in the United States but written in the London market. We began to use HCC International Insurance Company as a platform for much of the European and other international risks previously underwritten by Houston Casualty Company-London.

***HCC International Insurance Company***

HCC International Insurance Company PLC writes diversified financial products business, primarily surety, credit and professional indemnity products, and non-United States based London market account risks. HCC International Insurance Company has been in operation since 1982 and is domiciled in the United Kingdom. HCC International Insurance Company s 2009 gross written premium was $231.0 million. We intend to continue to expand the underwriting activities of HCC International Insurance Company and to use it as an integral part of a European platform for our international insurance operations.

***Lloyd s of London Syndicates***

We currently participate in Lloyd s of London Syndicate 4040, which writes business included in our other specialty lines of business, and Lloyd s of London Syndicate 4141, which writes business in our diversified financial products, London market account and group life, accident and health lines of business. These syndicates are managed by HCC Underwriting Agency, Ltd. (UK). Syndicate 4040 will merge into Syndicate 4141 in 2013, after the 2009 year of account is closed in accordance with Lloyd s rules. We expect to use our Lloyd s platform and the licenses it affords us to write business unique to Lloyd s and business in countries where our other insurance companies are not currently licensed.

***HCC Europe***

Houston Casualty Company Europe, Seguros y Reaseguros, S.A. is a Spanish insurer. It underwrites diversified financial products business. HCC Europe has been an issuing carrier for diversified financial products business underwritten by affiliated underwriting agencies. Beginning in 2010, this business will be underwritten by HCC International Insurance Company. HCC Europe has been in operation since 1978. HCC Europe s gross written premium in 2009 was $115.8 million.

***HCC Reinsurance Company***

HCC Reinsurance Company Limited is a Bermuda-domiciled reinsurance company that writes assumed reinsurance from our insurance companies and a limited amount of direct insurance. HCC Reinsurance Company is an issuing carrier for diversified financial products business underwritten by our underwriting agency, HCC Indemnity Guaranty. HCC Reinsurance Company s gross written premium in 2009 was $122.8 million.

***U.S. Specialty Insurance Company***

U.S. Specialty Insurance Company is a Texas-domiciled property and casualty insurance company. It primarily writes diversified financial products, aviation and accident and health business. U.S. Specialty Insurance Company acts as an issuing carrier for certain business underwritten by our underwriting agencies. U.S. Specialty Insurance Company s gross written premium in 2009 was $656.5 million.

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***HCC Life Insurance Company***

HCC Life Insurance Company is an Indiana-domiciled life insurance company. It operates as primarily a larger group life, accident and health insurer. Its primary products are medical stop-loss and medical excess business. This business is primarily produced by unaffiliated agents, brokers and third party administrators. HCC Life Insurance Company s gross written premium in 2009 was $674.8 million.

***Perico Life Insurance Company***

Perico Life Insurance Company is a Delaware-domiciled life insurance company. Perico Life Insurance Company now operates as primarily a small group life, accident and health insurer. Its principal product is medical stop-loss business. Perico Life Insurance Company s 2009 gross written premium was $84.1 million.

***Avemco Insurance Company***

Avemco Insurance Company is a Maryland-domiciled property and casualty insurer and operates as a direct market underwriter of general aviation business. It has also been an issuing carrier for accident and health business and some other lines of business underwritten by our underwriting agencies and a previously affiliated underwriting agency. Avemco Insurance Company s gross written premium in 2009 was $40.9 million.

***American Contractors Indemnity Company***

American Contractors Indemnity Company is a California-domiciled surety company. It writes court, specialty contract, license and permit, and bail bonds. American Contractors Indemnity Company has been in operation since 1990 and operates as a part of our HCC Surety Group. American Contractors Indemnity Company s 2009 gross written premium was $101.4 million.

***United States Surety Company***

United States Surety Company is a Maryland-domiciled surety company that has been in operation since 1996. It writes contract bonds and operates as a part of our HCC Surety Group. United States Surety Company s 2009 gross written premium was $22.2 million.

***HCC Specialty Insurance Company***

HCC Specialty Insurance Company is an Oklahoma-domiciled property and casualty insurance company in operation since 2002. It writes diversified financial products and other specialty lines of business produced by affiliated underwriting agencies. HCC Specialty Insurance Company s gross written premium in 2009 was $20.5 million and was 100% ceded to Houston Casualty Company.

**Underwriting Agency Operations**

Historically, we have acquired underwriting agencies with seasoned books of business and experienced underwriters. These agencies control the distribution of their business. After we acquire an agency, we generally begin to write some or all of its business through our insurance companies, and, in some cases, the insurance companies reinsure some of the business with unaffiliated reinsurers. We have consolidated certain of our underwriting agencies with our insurance companies when our retention of their business approached 100%. We plan to continue this process in the future.

Our underwriting agencies act on behalf of affiliated and unaffiliated insurance companies and provide insurance underwriting management and claims administration services. Our underwriting agencies do not assume any insurance or reinsurance risk themselves and generate revenues based entirely on fee income and profit commissions. These subsidiaries are in a position to direct and control business they produce. Our insurance companies serve as policy issuing companies for the majority of the business written by our underwriting agencies. If an unaffiliated insurance company serves as the policy issuing company, our insurance companies may reinsure all or part of the business. Our underwriting agencies generated total revenue in 2009 of $182.1 million.

***Professional Indemnity Agency***

Professional Indemnity Agency, Inc., based in Mount Kisco, New York and with operations in San Francisco and San Diego, California, Concord, California, Richmond, Virginia, Scottsdale, Arizona and Auburn Hills, Michigan, acts as an underwriting manager for diversified financial products specializing in directors and officers liability, errors and omissions liability, kidnap and ransom, employment practice liability, public entity, fidelity, difference in conditions (earthquake) and other specialty lines of business on behalf of affiliated and unaffiliated insurance companies. It has been in operation since 1977.

***HCC Specialty Underwriters***

HCC Specialty Underwriters Inc., with its home office in Wakefield, Massachusetts and a branch office in London, England, acts as an underwriting manager for sports disability, contingency, film production, and other group life, accident and health and specialty lines of business on behalf of affiliated and unaffiliated insurance companies. It has been in operation since 1982.

***HCC Global Financial Products***

HCC Global Financial Products, LLC acts as an underwriting manager for diversified financial products, specializing in directors and officers liability business on behalf of affiliated insurance companies. It has been in operation since 1999, underwriting domestic business from Farmington, Connecticut, Jersey City, New Jersey and Houston, Texas and international business from Barcelona, Spain, London, England, and Miami, Florida.

***HCC Indemnity Guaranty Agency***

HCC Indemnity Guaranty Agency, Inc. is an underwriting agency based in New York, New York, specializing in writing insurance and reinsurance related to various financial products. It writes on behalf of affiliated insurance companies. It has been in operation since 2004.

***HCC Underwriting Agency***

HCC Underwriting Agency, Ltd. (UK) is a managing agent for two Lloyd s of London syndicates, Syndicates 4040 and 4141. HCC Underwriting Agency, Ltd. (UK) has been in operation since 2004.

***HCC Medical Insurance Services***

HCC Medical Insurance Services, LLC, based in Indianapolis, Indiana, is an underwriting agency specializing in domestic and international short-term medical insurance, which is written principally through an internet platform. The domestic business is written on behalf of one of our domestic insurance companies and the international business is written by Lloyd s of London Syndicate 4141.

**Other Operations**

In the past, we invested in insurance related entities, had a trading portfolio of securities and issued a mortgage guaranty contract, which was accounted for utilizing deposit accounting. We have sold the trading portfolio and the investments and have commuted the mortgage guaranty contract. The income and gains and losses from these items are included in other operating income, together with other miscellaneous income and income related to two mortgage impairment insurance contracts which, while written as insurance policies, receive accounting treatment as derivative financial instruments.

Other operating income was $34.4 million in 2009, $9.6 million in 2008 and $43.5 million in 2007, and varied considerably from period to period depending on the amount of trading, investment or disposition activity and, in 2009, from the commutation.

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## Operating Ratios

### *Premium to Surplus Ratio*

Our insurance companies are subject to regulation and supervision by the jurisdictions in which they do business. Statutory accounting is generally based on a liquidation concept with the intent to protect the policyholders. This table shows the ratio of statutory gross written premium and net written premium to statutory policyholders surplus for our property and casualty insurance companies (dollars in thousands):

| | 2009 | 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|---|
| Gross written premium | $ 2,568,609 | $ 2,510,612 | $ 2,460,498 | $ 2,243,843 | $ 2,049,116 |
| Net written premium | 2,052,309 | 2,064,091 | 1,985,641 | 1,812,896 | 1,495,931 |
| **Policyholders surplus** | 2,103,892 | 1,852,684 | 1,744,889 | 1,342,054 | 1,110,268 |
| Gross written premium ratio | 122.1% | 135.5% | 141.0% | 167.2% | 184.6% |
| Gross written premium industry average(1) | * | 180.5% | 160.7% | 171.0% | 192.7% |
| Net written premium ratio | 97.5% | 111.4% | 113.8% | 135.1% | 134.7% |
| Net written premium industry average(1) | 82.2%** | 93.5% | 84.2% | 90.4% | 99.8% |

(1) Source: A.M. Best Company, Inc.

* Not available

** Estimated by A.M. Best Company, Inc.

While there is no statutory requirement regarding a permissible premium to policyholders surplus ratio, guidelines established by the National Association of Insurance Commissioners provide that a property and casualty insurer s annual statutory gross written premium should not exceed 900% and net written premium should not exceed 300% of its policyholders surplus. However, industry and rating agency guidelines place these ratios at 300% and 200%, respectively. Our property and casualty insurance companies have maintained ratios lower than such guidelines.

### *Combined Ratio GAAP*

The underwriting experience of a property and casualty insurance company is indicated by its combined ratio. The GAAP combined ratio is a combination of the loss ratio (the ratio of incurred losses and loss adjustment expenses to net earned premium) and the expense ratio (the ratio of policy acquisition costs and other underwriting expenses, net of ceding commissions, to net earned premium). We calculate the GAAP combined ratio using financial data derived from the combined financial statements of our insurance company subsidiaries reported under accounting principles generally accepted in the United States of America (generally accepted accounting principles or GAAP). Our insurance companies GAAP loss ratios, expense ratios and combined ratios are shown in the following table:

| | 2009 | 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Loss ratio | 59.7% | 60.4% | 59.6% | 59.2% | 67.1% |
| Expense ratio | 25.2 | 25.0 | 23.8 | 25.0 | 26.1 |
| **Combined ratio GAAP** | 84.9% | 85.4% | 83.4% | 84.2% | 93.2% |

***Combined Ratio Statutory***

The statutory combined ratio is a combination of the loss ratio (the ratio of incurred losses and loss adjustment expenses to net earned premium) and the expense ratio (the ratio of policy acquisition costs and other underwriting expenses, net of ceding commissions, to net written premium). We calculate the statutory combined ratio using financial data derived from the combined financial statements of our insurance company

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subsidiaries reported in accordance with statutory accounting principles. Our insurance companies statutory loss ratios, expense ratios and combined ratios are shown in the following table:

| | 2009 | 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|---|
| Loss ratio | 60.7% | 60.8% | 60.6% | 60.0% | 67.1% |
| Expense ratio | 25.7 | 24.3 | 23.9 | 24.0 | 25.5 |
| **Combined ratio Statutory** | 86.4% | 85.1% | 84.5% | 84.0% | 92.6% |
| Industry average | 100.6%* | 103.9% | 95.7% | 92.5% | 100.7% |

* Estimated by A.M. Best Company, Inc.

The statutory ratio data is not intended to be a substitute for results of operations in accordance with GAAP. We believe including this information is useful to allow a comparison of our operating results with those of other companies in the insurance industry. The source of the industry average is A.M. Best Company, Inc. A.M. Best Company, Inc. reports insurer performance based on statutory financial data to provide more standardized comparisons among individual companies and to provide overall industry performance. This data is not an evaluation directed at investors.

## Reserves

Our net loss and loss adjustment expense reserves are composed of reserves for reported losses and reserves for incurred but not reported losses (which include provisions for potential movement in reported losses, as well as for claims that have occurred but have not yet been reported to us). Reinsurance recoverables offset our gross reserves based upon the contractual terms of our reinsurance agreements. Reserves are recorded by product line and are undiscounted, except for reserves related to acquisitions.

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

To record reserves on our lines of business, we utilize expected loss ratios, which management selects based on the following:

- information used to price the applicable policies,
- historical loss information where available,
- any public industry data for that line or similar lines of business,
- an assessment of current market conditions, and

a claim-by-claim review by management, where actuarially homogenous data is unavailable.

Management also considers the point estimates and ranges calculated by our actuaries, together with input from our experienced underwriting and claims personnel. Our actuaries utilize standard actuarial techniques in making their actuarial point estimates. These techniques require a high degree of judgment, and changing conditions can cause fluctuations in the reserve estimates. Because of the nature and complexities of the specialized types of business we insure, management may give greater weight to the expectations of our underwriting and claims personnel, who often perform a claim by claim review, rather than to the actuarial estimates. However, we utilize the actuarial point and range estimates to monitor the adequacy and reasonableness of our recorded reserves.

Each quarter, management compares recorded reserves to the most recent actuarial point estimate and range for each line of business. If the recorded reserves vary significantly from the actuarial point estimate,

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management determines the reasons for the variances and may adjust the reserves up or down to an amount that, in management s judgment, is adequate based on all of the facts and circumstances considered, including the actuarial point estimates. We believe that our review process is effective, such that any required changes are recognized in the period of change as soon as the need for the change is evident. Our total consolidated net reserves have consistently been above the total actuarial point estimate but within the actuarial range.

With the exception of 2004, our net reserves historically have shown favorable development except for the effects of losses from commutations, which we have completed in the past and may negotiate in the future. 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 of the reserves; thus, the loss may be recouped as investment income is earned on the assets received. Based on our reserving techniques and our past results, we believe that our net reserves are adequate.

The reserving process is intended to reflect the impact of inflation and other factors affecting loss payments by taking into account changes in historical payment patterns and perceived trends. There is no precise method for the subsequent evaluation of the adequacy of the consideration given to inflation, or to any other specific factor, or to the way one factor may impact another.

We underwrite risks that are denominated in a number of foreign currencies and, therefore, maintain loss reserves with respect to these policies in the respective currencies. These reserves are subject to exchange rate fluctuations, which may have an effect on our net earnings. Generally, we match the reserves denominated in foreign currencies with assets denominated in the same currency resulting in a natural economic hedge that mitigates the effects of exchange rate fluctuation.

The loss development triangles show changes in our reserves in subsequent years from the prior loss estimates, based on experience at the end of each succeeding year, on the basis of generally accepted accounting principles. The estimate is increased or decreased as more information becomes known about the frequency and severity of losses for individual years. A redundancy means the original estimate was higher than the current estimate; a deficiency means that the current estimate is higher than the original estimate.

The first line of each loss development triangle presents, for the years indicated, our gross or net reserve liability, including the reserve for incurred but not reported losses. The first section of each table shows, by year, the cumulative amounts of loss and loss adjustment expense paid at the end of each succeeding year. The second section sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. The cumulative redundancy (deficiency) represents, at the date indicated, the difference between the latest re-estimated liability and the reserves as originally estimated.

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This loss development triangle shows development in loss reserves on a gross basis (in thousands):

| | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|---|---|---|
| ,309 | $ 3,415,230 | $ 3,227,080 | $ 3,097,051 | $ 2,813,720 | $ 2,089,199 | $ 1,525,313 | $ 1,158,915 | $ 1,132,258 |
| | 24,897 | 57,028 | 48,119 | 26,088 | 6,113 | | 5,587 | |
| ,309 | 3,440,127 | 3,284,108 | 3,145,170 | 2,839,808 | 2,095,312 | 1,525,313 | 1,164,502 | 1,132,258 |
| | 887,040 | 902,352 | 797,217 | 689,126 | 511,766 | 396,077 | 418,809 | 390,232 |
| | | 1,305,179 | 1,260,672 | 1,077,954 | 780,130 | 587,349 | 548,941 | 612,129 |
| | | | 1,527,443 | 1,385,011 | 993,655 | 772,095 | 659,568 | 726,805 |
| | | | | 1,578,970 | 1,144,350 | 866,025 | 823,760 | 803,152 |
| | | | | | 1,231,166 | 1,002,058 | 886,458 | 921,920 |
| | | | | | | 1,092,558 | 1,003,780 | 1,009,049 |
| | | | | | | | 1,078,739 | 1,101,393 |
| | | | | | | | | 1,167,307 |
| ,309 | 3,440,127 | 3,284,108 | 3,145,170 | 2,839,808 | 2,095,312 | 1,525,313 | 1,164,502 | 1,132,258 |
| | 3,349,692 | 3,244,195 | 3,054,549 | 2,836,507 | 2,124,584 | 1,641,426 | 1,287,003 | 1,109,098 |
| | | 3,070,059 | 2,966,388 | 2,725,035 | 2,118,416 | 1,666,931 | 1,393,143 | 1,241,261 |
| | | | 2,784,998 | 2,657,565 | 2,031,246 | 1,690,729 | 1,464,448 | 1,384,608 |
| | | | | 2,518,263 | 2,008,590 | 1,619,744 | 1,506,360 | 1,455,046 |
| | | | | | 1,943,902 | 1,639,621 | 1,453,674 | 1,480,193 |
| | | | | | | 1,617,970 | 1,467,540 | 1,433,630 |
| | | | | | | | 1,463,702 | 1,462,481 |
| | | | | | | | | 1,452,706 |
| | $ 90,435 | $ 214,049 | $ 360,172 | $ 321,545 | $ 151,410 | $ (92,657) | $ (299,200) | $ (320,448) |

The gross redundancies reflected in the above table for 2004 through 2008 resulted primarily from the following activity:

Excluding certain business described below, during 2009, 2008 and 2007, we recorded favorable development of $175.2 million, $106.2 million and $44.1 million, respectively. Most of this was from the 2002 2006 underwriting years in: 1) our diversified financial products line of business, primarily in our directors and officers liability, U.K. professional indemnity and U.S. surety products, 2) our London market account, which includes redundancies on the 2005 hurricanes, and 3) an assumed quota share program reported in our other specialty line of business. These changes primarily affected the 2003 through 2007 accident years.

As part of our 2009 reserve review, we re-estimated our exposure on our directors and officers liability business for the 2007 underwriting year, which resulted in $84.8 million of additional reserves in the 2007 and 2008 accident years.

During 2008, we recorded adverse development of $34.1 million on certain run-off assumed accident and health reinsurance business reported in our discontinued lines of business due to our continuing evaluation of reserves, primarily on the 2000 accident year. During 2007, we recorded favorable development of $46.5 million on the same run-off accident and health business. The combined effect of these entries was favorable development of $12.4 million.

The gross deficiencies reflected in the above table for 1999 through 2003 resulted from the following:

During 2005, 2004 and 2003, we recorded $49.8 million, $127.7 million and $132.9 million, respectively, in gross losses on certain run-off assumed accident and health reinsurance business

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reported in our discontinued lines of business, due to our processing of additional information received and our continuing evaluation of reserves on this business. Collectively, these transactions primarily affected the 1999, 2000 and 2001 accident years.

The 2000 and 1999 years were also adversely affected by late reporting of loss information received during 2001 for certain other discontinued business.

The gross reserves in the discontinued lines of business, particularly with respect to run-off assumed accident and health reinsurance business, produced substantial adverse development from 2003 through 2005. This assumed accident and health reinsurance is primarily excess coverage for large losses related to workers compensation policies. Losses tend to develop and affect excess covers considerably after the original loss was incurred. Additionally, certain primary insurance companies that we reinsured have experienced financial difficulty and some of them are in liquidation, with guaranty funds now responsible for administering the business. Losses related to this business are historically late reporting. While we attempt to anticipate these conditions in setting our gross reserves, we have only been partially successful to date, and there could be additional adverse development in these reserves in the future. The gross losses that have developed adversely have been substantially reinsured and, therefore, the net effects have been much less.

The following table provides a reconciliation of the gross liability for loss and loss adjustment expense payable on the basis of generally accepted accounting principles (in thousands):

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Gross reserves for loss and loss adjustment expense payable at beginning of year | $ 3,415,230 | $ 3,227,080 | $ 3,097,051 |
| Gross reserve additions from acquired businesses | 37,839 | 32,131 | 826 |
| Foreign currency adjustment | 31,844 | (102,777) | 34,202 |
| Incurred loss and loss adjustment expense: | | | |
| Provision for loss and loss adjustment expense for claims occurring in current year | 1,579,331 | 1,707,538 | 1,443,031 |
| Decrease in estimated loss and loss adjustment expense for claims occurring in prior years* | (90,435) | (72,044) | (90,621) |
| Incurred loss and loss adjustment expense | 1,488,896 | 1,635,494 | 1,352,410 |
| Loss and loss adjustment expense payments for claims occurring during: | | | |
| Current year | 594,460 | 474,346 | 460,192 |
| Prior years | 887,040 | 902,352 | 797,217 |
| Loss and loss adjustment expense payments | 1,481,500 | 1,376,698 | 1,257,409 |
| **Gross reserves for loss and loss adjustment expense payable at end of year** | $ 3,492,309 | $ 3,415,230 | $ 3,227,080 |

*

Changes in loss and loss adjustment expense reserves for losses occurring in prior years reflect the gross effect of the resolution of losses for other than the reserve value and the subsequent adjustments of loss reserves.

The activities that caused the 2004 2008 redundancies reported in the gross triangle and explained previously are the same activities that caused the gross redundant development for 2007 through 2009 reported in the above reconciliation.

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This loss development triangle shows development in loss reserves on a net basis (in thousands):

| 9 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 | 2 |
|---|---|---|---|---|---|---|---|---|---|
| ,840 | $ 2,416,271 | $ 2,342,800 | $ 2,108,961 | $ 1,533,433 | $ 1,059,283 | $ 705,200 | $ 458,702 | $ 313,097 | $ 2 |
| | 23,498 | 52,551 | 44,410 | 24,318 | 5,777 | | 5,587 | | |
| ,840 | 2,439,769 | 2,395,351 | 2,153,371 | 1,557,751 | 1,065,060 | 705,200 | 464,289 | 313,097 | 2 |
| | 618,699 | 687,675 | 556,096 | 222,336 | 172,224 | 141,677 | 115,669 | 126,019 | 1 |
| | | 940,636 | 858,586 | 420,816 | 195,663 | 135,623 | 152,674 | 131,244 | 1 |
| | | | 1,013,122 | 588,659 | 337,330 | 124,522 | 115,214 | 163,808 | 1 |
| | | | | 702,072 | 424,308 | 217,827 | 88,998 | 93,405 | 1 |
| | | | | | 495,642 | 313,315 | 155,708 | 59,936 | 1 |
| | | | | | | 376,903 | 242,904 | 125,311 | 1 |
| | | | | | | | 301,828 | 186,224 | 1 |
| | | | | | | | | 236,299 | 2 |
| | | | | | | | | | 2 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| ,840 | 2,439,769 | 2,395,351 | 2,153,371 | 1,557,751 | 1,065,060 | 705,200 | 464,289 | 313,097 | 2 |
| | 2,386,245 | 2,342,033 | 2,126,974 | 1,551,225 | 1,090,454 | 735,678 | 487,403 | 306,318 | 2 |
| | | 2,223,731 | 2,042,277 | 1,524,732 | 1,089,732 | 770,497 | 500,897 | 338,194 | 2 |
| | | | 1,917,156 | 1,450,866 | 1,083,749 | 792,099 | 571,403 | 366,819 | 2 |
| | | | | 1,367,143 | 1,046,110 | 808,261 | 585,741 | 418,781 | 2 |
| | | | | | 1,018,235 | 794,740 | 613,406 | 453,537 | 2 |
| | | | | | | 792,896 | 597,666 | 462,157 | 3 |
| | | | | | | | 602,546 | 455,279 | 3 |
| | | | | | | | | 452,221 | 3 |
| | | | | | | | | | 3 |
| | $ 53,524 | $ 171,620 | $ 236,215 | $ 190,608 | $ 46,825 | $ (87,696) | $ (138,257) | $ (139,124) | $ |

The net redundancies reflected in the above table for 2004 through 2008 resulted primarily from the following:

During 2009, 2008 and 2007, we recorded favorable development of $53.5 million, $82.4 millino and $26.4 million, respectively. Most of this was from the 2002 2006 underwriting years in: 1) our diversified financial products line of business, primarily in our directors and officers liability, U.K. professional indemnity and U.S. surety products, 2) our London market account, which includes redundancies on the 2005 hurricanes, and 3) an assumed quota share program reported in our other specialty line of business. These changes primarily affected the 2003 through 2007 accident years. As part of our 2009 reserve review, we re-estimated our exposure on our directors and officers liability 2007 underwriting year, which resulted in additional reserves for the 2007 and 2008 accident years.

Reserve reductions in 2006 on prior years hurricanes and aviation, affecting primarily the 2004 and 2005 accident years.

The net deficiencies reflected in the above table for 1999 through 2003 resulted primarily from activity on certain run-off assumed accident and health business reported in our discontinued lines of business, as follows:

Commutation charges of $20.2 million, $26.0 million and $28.8 million recorded in 2006, 2005 and 2003, respectively.

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Reserve strengthening of $27.3 million in 2004 to bring net reserves for this discontinued line of business above our actuarial point estimate.

Collectively, these transactions primarily affected the 1999, 2000 and 2001 accident years.

The table below provides a reconciliation of the liability for loss and loss adjustment expense payable, net of reinsurance ceded, on the basis of generally accepted accounting principles (in thousands):

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Net reserves for loss and loss adjustment expense payable at beginning of year | $ 2,416,271 | $ 2,342,800 | $ 2,108,961 |
| Net reserve additions from acquired businesses | 36,522 | 29,053 | 742 |
| Foreign currency adjustment | 25,067 | (82,677) | 27,304 |
| Incurred loss and loss adjustment expense: | | | |
| Provision for loss and loss adjustment expense for claims occurring in current year | 1,269,283 | 1,294,244 | 1,210,344 |
| Decrease in estimated loss and loss adjustment expense for claims occurring in prior years* | (53,524) | (82,371) | (26,397) |
| Incurred loss and loss adjustment expense | 1,215,759 | 1,211,873 | 1,183,947 |
| Loss and loss adjustment expense payments for claims occurring during: | | | |
| Current year | 519,080 | 397,103 | 422,058 |
| Prior years | 618,699 | 687,675 | 556,096 |
| Loss and loss adjustment expense payments | 1,137,779 | 1,084,778 | 978,154 |
| **Net reserves for loss and loss adjustment expense payable at end of year** | $ 2,555,840 | $ 2,416,271 | $ 2,342,800 |

* Changes in loss and loss adjustment expense reserves for losses occurring in prior years reflect the net effect of the resolution of losses for other than the reserve value and the subsequent adjustments of loss reserves.

The activities that caused the 2004 2008 redundancies reported in the net triangle and explained previously are the same activities that caused the net redundant development for 2007 through 2009 reported in the above reconciliation.

Deficiencies and redundancies in the reserves occur as we continually review our loss reserves with our actuaries, increasing or reducing loss reserves as a result of such reviews and as losses are finally settled and claims exposures are reduced. We believe we have provided for all material net incurred losses.

We write directors and officers liability, errors and omission liability and fiduciary liability coverages for public and private companies and not-for-profit organizations. Certain of this business is written for financial institutions that have potential exposure to shareholder lawsuits as a result of the current economic environment during the last few years. We also write trade credit business for policyholders who have credit and political risk exposure. We continue to closely monitor our exposure to subprime and credit market related issues. Based on our present knowledge, we believe our ultimate losses from these coverages will be contained within our current overall loss reserves for this business.

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

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## Enterprise Risk Management

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

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 Vice President of our Enterprise Risk Management Department, who reports to the President and Chief Executive Officer, A Risk Committee that reports to the President and Chief Executive Officer assists the Board in risk assessment.

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 catastrophe 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, and 5) the use of outside experts to perform scenario testing, where deemed beneficial. We plan to continue to invest in resources and technology to support our ERM process.

## Regulation

The business of insurance is extensively regulated by the government. At this time, the insurance business in the United States is regulated primarily by the individual states. Additional federal regulation of the insurance industry may occur in the future.

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. In all jurisdictions, the applicable laws and regulations are subject to amendment or interpretation by regulatory authorities. 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.

### *Insurance Companies*

Our insurance companies are subject to regulation and supervision by the states and by other jurisdictions in which they do business. Regulation by the states varies, but generally involves regulatory and supervisory powers exercised by a state insurance official. In the United States, the regulation and supervision of our insurance operations primarily entails:

- approval of policy forms and premium rates,
- licensing of insurers and their agents,
- periodic examinations of our operations and finances,

prescription of the form and content of records of financial condition to be filed with the regulatory authority,

required levels of deposits for the benefit of policyholders,

requiring certain methods of accounting,

requiring reserves for unearned premium, losses and other purposes, restrictions on the ability of our insurance companies to pay dividends,

restrictions on the nature, quality and concentration of investments,

restrictions on transactions between insurance companies and their affiliates,

restrictions on the size of risks insurable under a single policy, and

standards of solvency, including risk-based capital measurement (which is a measure developed by the National Association of Insurance Commissioners and used by state insurance regulators to identify insurance companies that potentially are inadequately capitalized).

In the United States, 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 the generally accepted accounting principles 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 liquidation concept, while generally accepted accounting principles are based on a going-concern concept.

In the United States, state insurance regulators classify direct insurance companies and some individual lines of business as admitted (also known as licensed ) insurance or non-admitted (also known as surplus lines ) insurance. Surplus lines insurance is offered by non-admitted companies on risks that are not insured in the particular state by admitted companies. All surplus lines insurance is required to be written through licensed surplus lines insurance brokers, who are required to be knowledgeable of and to follow specific state laws prior to placing a risk with a surplus lines insurer. Our insurance companies offer products on both an admitted and surplus lines basis.

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.

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

HCC Europe is domiciled in Spain and operates on the equivalent of an admitted basis throughout the European Union. 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).

***Underwriting Agencies***

In addition to the regulation of insurance companies, the states impose licensing and other requirements on the underwriting agency and service operations of our other subsidiaries. These regulations relate primarily to:

advertising and business practice rules,

contractual requirements,

financial security,

licensing as agents, brokers, reinsurance brokers, managing general agents or third party administrators, limitations on authority, and

recordkeeping requirements.

***Statutory Accounting Principles***

The principal differences between statutory accounting principles for our domestic insurance company subsidiaries and generally accepted accounting principles, the method by which we report our consolidated financial results to our shareholders, are as follows:

a liability is recorded for certain reinsurance recoverables under statutory accounting principles whereas, under generally accepted accounting principles, there is no such provision unless the recoverables are deemed to be doubtful of collection,

certain assets that are considered non-admitted assets are eliminated from a balance sheet prepared in accordance with statutory accounting principles, but are included in a balance sheet prepared in accordance with generally accepted accounting principles,

only some of the deferred tax asset is recognized under statutory accounting principles,

fixed income investments classified as available for sale are recorded at fair value for generally accepted accounting principles and at amortized cost under statutory accounting principles,

outstanding losses and unearned premium are reported on a gross basis under generally accepted accounting principles and on a net basis under statutory accounting principles, and

under statutory accounting principles, policy acquisition costs are expensed as incurred and, under generally accepted accounting principles, such costs are deferred and amortized to expense as the related premium is earned.

Our international insurance company subsidiaries accounting principles are prescribed by regulatory authorities in each country. The prescribed principles do not vary significantly from generally accepted accounting principles.

***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.

***Assessments***

Many states require insurers licensed to do business in the state to bear a portion of the loss suffered by some insureds as a result of the insolvency of other insurers or to bear a portion of the cost of insurance for high-risk or otherwise uninsured individuals. Depending upon state law, insurers can be assessed an amount that is generally limited to between 1% and 2% of premiums written for the relevant lines of insurance in that state. Part of these payments may be recoverable through premium rates, premium tax credits or policy surcharges. Significant increases in assessments could limit the ability of our insurance subsidiaries to recover such assessments through tax credits or other means. In addition, there have been some legislative efforts to limit policy surcharges or repeal the tax offset provisions. We cannot predict the extent to which such assessments may increase or whether there may be limits imposed on our ability to recover or offset such assessments.

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### *Insurance Regulations Concerning Change of 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. HCC owns, 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 transaction 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 which could be beneficial to our shareholders.

### *Risk-Based Capital*

The National Association of Insurance Commissioners has developed a formula for analyzing insurance companies called risk-based capital. The risk-based capital formula 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, 2009, each of our domestic insurance companies total adjusted capital was significantly in excess of the authorized control level risk-based capital.

### *Insurance Regulatory Information System*

The National Association of Insurance Commissioners has developed a rating system, the Insurance Regulatory Information System, primarily intended to assist state insurance departments in overseeing the financial condition of all insurance companies operating within their respective states. The Insurance Regulatory Information System consists of eleven key financial ratios that address various aspects of each insurer s financial condition and stability. Our insurance companies Insurance Regulatory Information System ratios generally fall within the usual prescribed ranges.

### *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 Extension Act of 2005 extended TRIA through December 31, 2007. In 2007, the President signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2007 (Reauthorization Act). The Reauthorization Act extends the program through December 31, 2014. A major provision of the Reauthorization Act is the revision of 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 sets the Federal share of compensation (subject to a $100.0 million program trigger) for program years 2008 2014 at 85%, excess of our retention level, up to the maximum annual liability cap 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. The Reauthorization Act also established a deductible that each insurer would have to meet before Federal reimbursement would occur. For 2010, our deductible is approximately $122.7 million.

***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 National Association of Insurance Commissioners, which seeks to promote uniformity of and to enhance the state regulation of insurance. In addition, the National Association of Insurance Commissioners and state insurance regulators, as part of the National Association of Insurance Commissioners 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 federal level to reform the current process of Federal and state regulation of the financial services industries in the United States, 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 Federal government has from time to time considered whether to impose overall federal regulation of insurers. If so, we believe state regulation of the insurance business would likely continue. This could result in an additional layer of federal regulation. 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 have cooperated fully with any such investigations and, based on presently available information, do not expect any adverse results from such investigations.

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, have a material adverse effect on our business or our results of operations.

**Employees**

At December 31, 2009, we had 1,864 employees. Of this number, 965 are employed by our insurance companies, 616 are employed by our underwriting agencies and 283 are employed at the corporate headquarters and elsewhere. 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.

## 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, windstorms, earthquakes, hailstorms, explosions, flooding, severe winter weather and fires and may include man-made events, such as terrorist attacks. 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 London market account. 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. Current events, such as the recent subprime issues, the state of the financial markets, the economic downturn and the severe decline in 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 reserves 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 now being experienced 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.

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***We may be impacted by claims relating to the recent credit market downturn and subprime insurance exposures.***

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 recent financial downturn has had an impact on this segment of the industry. As a result, this industry segment 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 condition 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. 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 extreme turmoil in the financial markets, combined with a new Congress and Presidential administration in the U.S. has increased the likelihood of changes in the way the financial services industry is regulated and how health care insurance is provided. It is possible that insurance regulation will be drawn into this process, and that federal regulatory initiatives in the insurance industry could emerge and new regulations could be implemented, possibly on an expedited basis. The future impact of any such initiatives and any resulting regulations on our results of operations or our financial condition cannot be determined at this time.

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The European Union 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 2012. We could be impacted by the implementation of Solvency II, depending on the costs associated with implementation by each EU country, any increased capitalization requirements applicable to us and any costs associated with adjustments to our operations.

***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, better capitalized 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 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 the current volatility in the financial markets and the economic downturn.

***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 line 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 2010 up to the maximum amount set out in the Reauthorization Act. However, any such coverage would be subject to a mandatory deductible. Our deductible under the Reauthorization Act during 2010 is approximately $122.7 million.

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 this law is relatively new and its interpretation 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.***

In our specialty insurance operations, we compete in narrowly-defined niche classes of business such as the insurance of private aircraft (aviation), directors and officers liability (diversified financial products), employer sponsored, self-insured medical plans (medical stop-loss), errors and omissions liability (diversified financial products) and surety (diversified financial products), as distinguished from such general lines of business as automobile or homeowners insurance. We compete with a large number of other companies in our selected lines of business, including: Lloyd s of London, ACE and XL in our London market business; American International Group and U.S. Aviation Insurance Group (a subsidiary of Berkshire Hathaway, Inc.) in our aviation line of business; United

Health and Symetra Financial Corp. in our group life, accident and health business; and American International Group, The Chubb Corporation, ACE, St. Paul Travelers and XL in our diversified financial products business. We face competition from 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. Furthermore, due to continuing volatility in the financial markets and 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 you 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.

***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 this period of stress 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 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.

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

At December 31, 2009, $4.6 billion of our $5.5 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 volatilities 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, 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 other 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 when there is a risk that the timing of cash flows that result from the repayment of principal might occur earlier than anticipated because of declining interest rates or extension risk when cash flows may be received later than anticipated because of rising interest rates. For mortgage-backed securities, credit risk exists if mortgagees default on the underlying mortgages. Notwithstanding the relatively low historical rates of default on many of these obligations, during an economic downturn, our municipal bond portfolio could be subject to a higher risk of default or impairments due to declining municipal tax bases and revenue. Although we maintain an investment grade portfolio (97% are rated A or better), all of our fixed income securities are subject to credit risk. 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 issurer defaults, we could have realized losses associated with the impairment of the securities.

The impact of market fluctuations 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. Unrealized pretax net investment gains (losses) on investments in fixed income securities were $141.7 million in 2009, $(10.4) million in 2008 and $26.7 million in 2007.

In 2007 and 2008 and continuing in 2009, 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 could adversely affect the valuation of our investments and cause us to have to record other-than-temporary impairment losses on our investments, which could have a material adverse effect on our financial position and result of operations.

***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. 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 we do not hold offsetting positions. 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 materially 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 all of 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. It is critical that these facilities and infrastructure remain secure. Despite the implementation of security measures, this infrastructure 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.

***The administration in Washington, D.C. is a proponent of potential changes in the country s health care delivery system.***

The administration is Washington, D.C. has as one of its key goals to significantly increase the percentage of the population that is covered for health care costs. This may result in significant changes in our health care delivery system in the United States. The type and scope of changes, if any, are not known at this time, but, if changes are made, they could have a material adverse effect on the volume and profitability of our medical stop-loss, medical excess and short-term medical insurance products.

***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.

***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 condition. 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.

## Item 1B. *Unresolved Staff Comments*

None.

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## 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 principal office facilities are as follows:

| Subsidiary | Segment | Location | Sq. Ft. | Termination Date of Lease |
|---|---|---|---|---|
| Houston Casualty Company | Insurance Company | Houston, Texas | 77,000 | Owned |
| HCC and Houston Casualty Company | Insurance Company and Corporate | Houston, Texas | 51,000 | Owned |
| HCC Surety Group | Insurance Company | Los Angeles, California | 40,000 | May 31, 2017 |
| Professional Indemnity Agency | Agency | Mount Kisco, New York | 38,000 | Owned |
| HCC International Insurance Company | Insurance Company | London, England | 30,000 | December 24, 2015 |
| HCC Life Insurance Company | Insurance Company | Atlanta, Georgia | 29,000 | December 31, 2011 |
| HCC Specialty Underwriters | Agency | Wakefield, Massachusetts | 28,000 | December 31, 2010 |
| U.S. Specialty Insurance Company-Aviation Division | Insurance Company | Dallas, Texas | 28,000 | August 31, 2013 |
| G. B. Kenrick & Associates, Inc. | Agency | Auburn Hills, Michigan | 27,000 | May 31, 2012 |
| HCC Life Insurance Company | Insurance Company | Minneapolis, Minnesota | 25,000 | September 30, 2012 |

See also Note 13 to our Consolidated Financial Statements included in this Form 10-K.

## 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 have a material adverse effect on our consolidated financial position, results of operations or cash flows.

**Item 4.** ***Reserved***

# 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, 2008 through December 31, 2009, as reported by the New York Stock Exchange, were as follows:

| | 2009 | | 2008 | |
|---|---|---|---|---|
| | High | Low | High | Low |
| First quarter | $ 26.68 | $ 20.07 | $ 29.03 | $ 21.26 |
| Second quarter | 27.54 | 23.02 | 25.99 | 20.48 |
| Third quarter | 28.81 | 23.42 | 30.00 | 19.12 |
| Fourth quarter | 29.01 | 25.58 | 26.95 | 14.17 |

On February 19, 2010, the last reported sales price of our common stock as reported by the New York Stock Exchange was $28.24 per share.

## Shareholders

We have one class of authorized capital stock: 250.0 million shares of common stock, par value $1.00 per share. On February 19, 2010, there were 119.2 million shares of common stock issued and 114.6 million shares of common stock outstanding held by 716 shareholders of record; however, we estimate there are approximately 76,000 beneficial owners.

## Dividend Policy

Cash dividends declared on a quarterly basis in 2009 and 2008 were as follows:

| | 2009 | 2008 |
|---|---|---|
| First quarter | $ .125 | $ .110 |
| Second quarter | .125 | .110 |
| Third quarter | .135 | .125 |
| Fourth quarter | .135 | .125 |

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.

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## Issuer Purchases of Equity Securities

On June 20, 2008, our Board of Directors approved the repurchase of up to $100.0 million of common stock. The share repurchase plan authorized repurchases to be made in the open market or in privately negotiated transactions from time-to-time in compliance with applicable rules and regulations, including Rule 10b-18 under the Securities Exchange Act of 1934, as amended. Repurchases under the plan were subject to market and business conditions, as well as the Company s level of cash generated from operations, cash required for acquisitions, debt covenant compliance, trading price of the stock being at or below book value and other relevant factors. The repurchase plan did not obligate the Company to purchase any particular number of shares, and may be suspended or discontinued at any time at the Company s discretion. As of December 31, 2009, we had repurchased $98.8 million or 4.7 million shares of our common stock in the open market pursuant to our repurchase program.

## Performance Graph

The following graph shows a comparison of cumulative total returns for an investment of $100.00 made on December 31, 2004 in the common stock of HCC Insurance Holdings, Inc., the Standard & Poor s Composite 1500 Index and the Standard & Poor s Midcap 400 Index. The graph assumes that all dividends were reinvested.

**COMPARISON OF CUMULATIVE FIVE YEAR TOTAL RETURN**

**Total Return to Shareholders**
**(includes reinvestment of dividends)**

| Company/Index | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|
| HCC Insurance Holdings, Inc. | $ 100.00 | $ 136.15 | $ 148.94 | $ 134.97 | $ 128.35 | $ 136.89 |
| S&P Composite 1500 Index | 100.00 | 105.66 | 121.86 | 128.52 | 81.33 | 103.49 |
| S&P Midcap 400 Index | 100.00 | 112.56 | 124.17 | 134.08 | 85.50 | 117.46 |

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.

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## 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, the related Notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Report.

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (in thousands, except per share data) | | | | |
| **Statement of earnings data** | | | | | |
| Revenue | | | | | |
| Net earned premium | $ 2,037,235 | $ 2,007,774 | $ 1,985,086 | $ 1,709,189 | $ 1,369,988 |
| Fee and commission income | 103,690 | 125,201 | 140,092 | 137,131 | 132,628 |
| Net investment income | 191,965 | 164,751 | 206,462 | 152,804 | 98,851 |
| Other operating income | 34,391 | 9,638 | 43,545 | 77,012 | 39,773 |
| Net realized investment gain (loss) | 12,076 | (16,808) | 13,188 | (841) | 1,448 |
| Other-than-temporary impairment loss: | | | | | |
| Total loss | (6,443) | (11,133) | | | |
| Portion recognized in other comprehensive income | 1,014 | | | | |
| Net loss recognized in earnings | (5,429) | (11,133) | | | |
| **Total revenue** | 2,373,928 | 2,279,423 | 2,388,373 | 2,075,295 | 1,642,688 |
| Expense | | | | | |
| Loss and loss adjustment expense, net | 1,215,759 | 1,211,873 | 1,183,947 | 1,011,856 | 919,697 |
| Policy acquisition costs, net | 363,966 | 381,441 | 366,610 | 319,885 | 261,708 |
| Other operating expense | 259,488 | 233,509 | 241,642 | 222,324 | 180,990 |
| Interest expense | 16,164 | 20,362 | 16,270 | 18,128 | 14,126 |
| **Total expense** | 1,855,377 | 1,847,185 | 1,808,469 | 1,572,193 | 1,376,521 |
| Earnings from continuing operations before income tax expense | 518,551 | 432,238 | 579,904 | 503,102 | 266,167 |
| Income tax expense on continuing operations | 164,683 | 130,118 | 188,351 | 165,191 | 81,921 |
| Earnings from continuing operations | 353,868 | 302,120 | 391,553 | 337,911 | 184,246 |
| Earnings from discontinued operations, net of income taxes(1) | | | | | 2,760 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Net earnings** | $ | 353,868 | $ | 302,120 | $ | 391,553 | $ | 337,911 | $ | 187,006 |

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| | Years Ended December 31, 2009 | 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|---|
| | (in thousands, except per share data) | | | | |
| **Basic earnings per share data** | | | | | |
| Earnings from continuing operations | $ 3.14 | $ 2.63 | $ 3.47 | $ 3.04 | $ 1.74 |
| Earnings from discontinued operations(1) | | | | | 0.03 |
| **Net earnings** | $ 3.14 | $ 2.63 | $ 3.47 | $ 3.04 | $ 1.77 |
| Weighted average shares outstanding | 112,200 | 114,848 | 112,873 | 111,309 | 105,463 |
| **Diluted earnings per share data** | | | | | |
| Earnings from continuing operations | $ 3.11 | $ 2.61 | $ 3.35 | $ 2.89 | $ 1.68 |
| Earnings from discontinued operations(1) | | | | | 0.03 |
| **Net earnings** | $ 3.11 | $ 2.61 | $ 3.35 | $ 2.89 | $ 1.71 |
| Weighted average shares outstanding | 113,058 | 115,463 | 116,997 | 116,736 | 109,437 |
| Cash dividends declared, per share | $ 0.520 | $ 0.470 | $ 0.420 | $ 0.375 | $ 0.282 |

| | December 31, 2009 | 2008 | 2007 | 2006 | 2005 |
|---|---|---|---|---|---|
| | (in thousands, except per share data) | | | | |
| **Balance sheet data** | | | | | |
| Total investments | $ 5,456,229 | $ 4,804,283 | $ 4,672,277 | $ 3,927,995 | $ 3,257,428 |
| Premium, claims and other receivables | 600,332 | 770,823 | 763,401 | 864,705 | 884,654 |
| Reinsurance recoverables | 1,016,411 | 1,054,950 | 956,665 | 1,169,934 | 1,361,983 |
| Ceded unearned premium | 270,436 | 234,375 | 244,684 | 226,125 | 239,416 |
| Goodwill | 822,006 | 858,849 | 776,046 | 742,677 | 532,947 |
| **Total assets** | 8,834,391 | 8,332,000 | 8,074,520 | 7,626,025 | 7,022,231 |
| Loss and loss adjustment expense payable | 3,492,309 | 3,415,230 | 3,227,080 | 3,097,051 | 2,813,720 |
| Unearned premium | 1,044,747 | 977,426 | 943,946 | 920,350 | 807,109 |
| Premium and claims payable | 154,596 | 405,287 | 497,974 | 646,224 | 753,859 |
| Notes payable | 298,483 | 343,649 | 319,471 | 297,574 | 291,394 |
| **Shareholders equity** | 3,031,183 | 2,640,023 | 2,443,695 | 2,050,009 | 1,702,015 |
| Book value per share(2) | $ 26.58 | $ 23.27 | $ 21.24 | $ 18.35 | $ 15.36 |

(1) Discontinued operations in 2005 represent gains from a contractual earnout related to the 2003 sale of our retail brokerage operation, HCC Employee Benefits, Inc.

(2) Book value per share is calculated by dividing outstanding shares into total shareholders equity.

**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, the Consolidated Financial Statements and the related Notes thereto.

**Overview**

We are a specialty insurance group with offices in the United States, the United Kingdom, Spain and Ireland, transacting business in approximately 150 countries. Our group consists of insurance companies, underwriting agencies and participation in two Lloyd s of London syndicates that we manage. Our shares trade on the New York Stock Exchange and closed at $27.97 on December 31, 2009 and $28.24 on February 19, 2010. We had a market capitalization of $3.2 billion at February 19, 2010.

We underwrite a variety of relatively non-correlated specialty lines of business identified as diversified financial products; group life, accident and health; aviation; London market account; and other specialty lines of business. Products in each line are marketed by our insurance companies, agencies and syndicates, through a network of independent agents and brokers, directly to customers or through third party administrators. The majority of our business is low limit or small premium business that has less intense price competition, as well as lower catastrophe and volatility risk. We reinsure a significant portion of our catastrophic exposure to hurricanes and earthquakes to minimize the impact on our net earnings and shareholders equity.

Key facts about our consolidated group as of and for the year ended December 31, 2009 are as follows:

- We had consolidated shareholders equity of $3.0 billion. Our book value per share increased 14% to $26.58.
- We had net earnings of $353.9 million, or $3.11 per diluted share.
- We generated $582.8 million of cash flow from operations.
- We produced $2.4 billion of total revenue, which was $94.5 million, or 4%, higher than in 2008.
- Our loss ratio was 59.7% and our combined ratio was 84.9%. Profitability from our underwriting operations remains at acceptable levels.
- We declared dividends of $0.52 per share and paid $57.4 million of dividends.
- We have $4.6 billion of fixed income securities with an average rating of AA+.
- We repurchased 1.7 million shares of our common stock for $35.5 million, or an average cost of $21.36 per share. In the past two years, we have repurchased 4.7 million shares for $98.8 million, or an average cost of $21.14 per share.
- We issued $300.0 million of 6.3% Senior Notes that mature in 2019.
- We redeemed the remaining $124.7 million of our 1.30% convertible debt.
- Our $575.0 million Revolving Loan Facility, which expires in December 2011, had no borrowings outstanding at December 31, 2009. The facility has an interest rate of 30-day LIBOR plus 25 basis points.

Our major domestic and international insurance companies have a financial strength rating of AA (Very Strong) from Standard & Poor s Corporation. Our major domestic insurance companies have a financial strength rating of AA (Very Strong) from Fitch Ratings, A1 (Good Security) from Moody s Investors Service, Inc., and A+ (Superior) by A.M. Best Company, Inc.

See the Results of Operations section below for additional discussion about the comparative effect of these items year-over-year.

During the past several years, we substantially increased our shareholders equity by retaining most of our earnings. With this additional equity, we increased the underwriting capacity of our insurance companies and made strategic acquisitions, adding new lines of business or expanding those with favorable underwriting characteristics. During the past three years, we completed eight business acquisitions, for total consideration of $101.0 million. Net earnings and cash flows from each acquired entity are included in our operations beginning on the effective date of each transaction.

The following section discusses our key operating results. The reasons for any significant variations between 2008 and 2007 are the same as those discussed for variations between 2009 and 2008, unless otherwise noted. Amounts in the following tables are in thousands, except for earnings per share, percentages, ratios and number of employees.

## Results of Operations

Net earnings were $353.9 million ($3.11 per diluted share) in 2009, compared to $302.1 million ($2.61 per diluted share) in 2008 and $391.6 million ($3.35 per diluted share) in 2007. The increase in net earnings for 2009 compared to 2008 primarily resulted from: 1) the 2009 commutation of a reinsurance contract that had been accounted for using the deposit method of accounting, 2) catastrophic losses in 2008 from the 2008 hurricanes, and 3) investment-related losses in 2008, as described more fully below. The decrease in net earnings for 2008 compared to 2007 primarily resulted from: 1) the investment-related losses in 2008 compared to income from these same investments in 2007, 2) the 2008 hurricane losses, and 3) the gain from sale of a strategic investment in 2007. Diluted earnings per share in 2009 and 2008 benefited from the repurchase of 1.7 million shares of our common stock in 2009 and 3.0 million shares of our common stock in 2008. The share repurchases reduced our diluted weighted-average shares outstanding, which were 113.1 million in 2009 and 115.5 million in 2008, compared to 117.0 million in 2007.

The following items affected pretax earnings in 2009, 2008 and 2007:

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Pretax earnings (loss) from: | | | |
| Commutation of reinsurance contract, net of related costs | $ 15,600 | $ | $ |
| Prior years reserve development | 53,524 | 82,371 | 26,397 |
| 2008 hurricanes (including reinsurance reinstatement premium) | | (22,304) | |
| Alternative investments | (958) | (30,766) | 23,930 |
| Net realized investment gain (loss) (excluding 2007 foreign currency gain) | 12,076 | (16,808) | (209) |
| Other-than-temporary impairments (recognized in earnings) | (5,429) | (11,133) | |
| Trading securities | | (11,698) | 3,881 |
| Sales of strategic investments and subsidiary, net | (2,266) | 9,158 | 21,618 |

In 2009, we commuted, loss-free, all liability under a contract to provide reinsurance coverage for certain residential mortgage guaranty contracts. We had been recording revenue under this contract using the deposit method of accounting because we determined the contract did not transfer significant underwriting risk. We received a cash termination payment of $25.0 million. As a result of the termination, other operating income increased $20.5 million, and fee and commission income increased $5.0 million. This additional revenue was offset by $9.9 million of expenses for reinsurance and other direct costs, which were recorded in other operating expense.

In 2009, we had $53.5 million of favorable development of our prior years net loss reserves, primarily from our: 1) U.K. professional indemnity business, 2) the 2005 hurricanes and 3) an assumed quota share contract. We had favorable development of $82.4 million in 2008 and $26.4 million in 2007, primarily from those same lines, as well as our U.S. surety business. The redundancies in the three-year period related to our 2002-2006 underwriting years.

In 2008, we incurred gross losses of $98.2 million from Hurricanes Gustav and Ike (referred to herein as the 2008 hurricanes ). Our pretax loss after reinsurance was $22.3 million, which included

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$19.4 million of losses reported in loss and loss adjustment expense and $2.9 million of premiums to reinstate our excess of loss reinsurance protection, which reduced net earned premium.

In 2008 and 2007, we held alternative investments that generated $30.8 million of market-related losses and $23.9 million of income, respectively. We redeemed the investments in late 2008 and received $94.1 million of cash in 2009, which we reinvested in fixed income securities.

We had a net realized investment gain of $12.1 million from the sale of securities in 2009, compared to a $16.8 million loss in 2008 and a $13.2 million gain in 2007. In 2008, to manage credit-related risk in our investment portfolio, we sold all of our investments in preferred stock and certain bonds of entities that were experiencing financial difficulty, and recognized a realized investment loss of $23.4 million. The 2007 gain included $13.4 million of embedded currency conversion gains on certain available for sale fixed income securities that we sold, which was offset by a $13.4 million foreign currency loss recorded in other operating expense.

We recognized, through earnings, other-than-temporary impairment losses of $5.4 million in 2009 and $11.1 million in 2008 on securities in our available for sale securities portfolio. There were no other-than-temporary impairment losses in 2007.

In 2008 and 2007, our former trading portfolio had losses of $11.7 million and gains of $3.9 million, respectively. We sold the final two positions in 2008.

In 2009, we sold a strategic investment and realized a gain of $2.4 million, which was offset by a $4.7 million loss related to the sale of a subsidiary. In 2008 and 2007, we sold strategic investments and realized gains of $9.2 million and $21.6 million, respectively.

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

| | **2009** | **2008** | **2007** |
|---|---|---|---|
| Net earned premium | 85.8% | 88.1% | 83.1% |
| Fee and commission income | 4.4 | 5.5 | 5.9 |
| Net investment income | 8.1 | 7.2 | 8.6 |
| Net realized investment and other-than-temporary gain (loss) | 0.3 | (1.2) | 0.6 |
| Other operating income | 1.4 | 0.4 | 1.8 |
| Total revenue | 100.0 | 100.0 | 100.0 |
| Loss and loss adjustment expense, net | 51.2 | 53.2 | 49.6 |
| Policy acquisition costs, net | 15.3 | 16.7 | 15.4 |
| Other operating expense | 11.0 | 10.2 | 10.1 |
| Interest expense | 0.7 | 0.9 | 0.6 |
| Earnings before income tax expense | 21.8 | 19.0 | 24.3 |
| Income tax expense | 6.9 | 5.7 | 7.9 |
| **Net earnings** | 14.9% | 13.3% | 16.4% |

***Revenue***

We generate our revenue from five primary sources:

- risk-bearing earned premium produced by our insurance companies and syndicates,
- non-risk-bearing fee and commission income received by our underwriting agencies,
- investment income earned by all of our operations,
- other operating income and losses, mainly related to strategic investments and events that do not occur each year, and

realized investment gains and losses and other-than-temporary impairment credit losses related to our fixed income securities portfolio.

Total revenue increased $94.5 million or 4% in 2009, compared to 5% decrease in 2008. The 2009 increase was due to: 1) higher net earned premium, 2) $25.0 million related to the commutation of a reinsurance contract in 2009 that had been accounted for using the deposit method of accounting, and 3) losses in 2008 on fixed income investments, alternative investments and trading securities, mainly due to the credit crisis. Although net earned premium was higher in 2008 than in 2007, the losses on fixed income investments, alternative investments and trading securities in 2008 reduced total revenue compared to 2007.

Gross written premium, net written premium and net earned premium are detailed below. In 2009, written premium reflects growth in our diversified financial products and London market account lines of business and from our 2008 acquisitions. Written premium also reflects reductions due to the discontinuance, in 2008, of an assumed quota share agreement and our U.K. motor business. Premium increased in 2008 principally from growth in our diversified financial products and other specialty lines of business and from acquisitions. Net written premium and net earned premium increased for the same reasons, as well as from higher retentions and lower reinsurance costs. See the Insurance Company Segment section below for additional discussion about the relationships and changes in premium revenue by line of business.

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| **Gross written premium** | $ 2,559,791 | $ 2,498,763 | $ 2,451,179 |
| **Net written premium** | 2,046,289 | 2,060,618 | 1,985,609 |
| **Net earned premium** | 2,037,235 | 2,007,774 | 1,985,086 |

The table below shows the source of our fee and commission income. The 17% decrease in 2009 primarily related to: 1) lower third party agency and broker commissions, 2) the sale of our reinsurance broker in the fourth quarter of 2009, 3) the sale of the operations of our commercial marine agency business in the second quarter of 2009 and 4) lower income from reinsurance overrides and profit commissions on quota share treaties, partially offset by 5) the $5.0 million termination payment in 2009 for commutation of a reinsurance contract that had been accounted for using the deposit method of accounting. The lower fee and commission income in 2008 resulted from a higher percentage of business being written directly by our insurance companies rather than being underwritten on behalf of third party insurance companies by our underwriting agencies, and higher retentions on certain lines of business.

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Agencies | $ 75,527 | $ 81,521 | $ 92,230 |
| Insurance companies | 28,163 | 43,680 | 47,862 |
| **Fee and commission income** | $ 103,690 | $ 125,201 | $ 140,092 |

The sources of our net investment income are detailed below.

| | 2009 | 2008 | 2007 |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Fixed income securities | | | |
| Taxable | $ 106,690 | $ 98,538 | $ 88,550 |
| Exempt from U.S. income taxes | 82,760 | 76,172 | 62,044 |
| Total fixed income securities | 189,450 | 174,710 | 150,594 |
| Short-term investments | 3,230 | 20,931 | 37,979 |
| Other | 3,086 | (26,949) | 23,715 |
| Total investment income | 195,766 | 168,692 | 212,288 |
| Investment expense | (3,801) | (3,941) | (5,826) |
| **Net investment income** | $ 191,965 | $ 164,751 | $ 206,462 |

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Net investment income increased 17% in 2009 and decreased 20% in 2008. The 2009 increase was due to higher income from fixed income securities in 2009, generated from an increased level of investments, combined with the effect of the losses on alternative investments (primarily fund-of-fund hedge fund investments) in 2008. This increase was partially offset by our earning less income on short-term investments in 2009, due to significantly lower short-term market interest rates. The 2008 decrease in net investment income was primarily due to the effect of our alternative investments, which generated $30.8 million of losses in 2008 compared to $23.9 million of income in 2007. These investments were impacted by the severe decline in the equity and debt markets. We eliminated our exposure to alternative investments by notifying the fund managers in late 2008 that we planned to liquidate these investments. At December 31, 2008, our alternative investment portfolio was $46.0 million and we also had a $52.6 million receivable for redemption proceeds in the process of liquidation. During 2009, we collected substantially all of the redeemed funds and reinvested the proceeds in fixed income securities. Our 2007 investment expense was higher due to the cost of managing the alternative investment portfolio.

Investment income on our fixed income securities increased 8% in 2009 and 16% in 2008 due to growth in fixed income investments. Our portfolio increased $384.2 million in 2009 to $4.6 billion at December 31, 2009, compared to $4.3 billion at December 31, 2008 and $3.7 billion at December 31, 2007. The higher balances of fixed income securities in 2009 and 2008 resulted from: 1) cash flow from operations, 2) the increase in net loss reserves (particularly from our diversified financial products line of business, which generally has a longer time period between receipt of premium and reporting and payment of claims), 3) reinvestment of the redeemed alternative investments in 2009 and 4) the increase in fair value in 2009.

Other operating income increased $24.8 million in 2009 and decreased $33.9 million in 2008. The following table details the components of other operating income.

| | **2009** | **2008** | **2007** |
|---|---|---|---|
| Contract using deposit accounting | $ 20,532 | $ 2,013 | $ |
| Strategic investments | 4,538 | 12,218 | 27,627 |
| Trading securities | | (11,698) | 3,881 |
| Financial instruments | 4,703 | (608) | 5,572 |
| Sale of subsidiary | (4,678) | | |
| Sale of non-operating assets | | 2,972 | 2,051 |
| Other | 9,296 | 4,741 | 4,414 |
| **Other operating income** | $ 34,391 | $ 9,638 | $ 43,545 |

The 2009 increase is due to a $20.0 million termination payment in 2009 to commute a reinsurance contract written in 2008 that had been accounted for using the deposit method of accounting. We entered into this agreement to provide reinsurance coverage for certain residential mortgage guaranty contracts. We recorded this contract using the deposit method of accounting, whereby all consideration received was initially recorded as a deposit liability and the changes in the deposit liability were recorded as a component of other operating income. The income from strategic investments relates to gains from selling different strategic investments in each year. The 2008 other operating income included losses from the decline in the market value of our trading securities, which we sold in 2008. The change in income from financial instruments was due to the effect on their value of foreign currency fluctuations in the British pound sterling compared to the U.S. dollar. In 2009, we sold 100% of the stock of our reinsurance broker, Rattner Mackenzie Limited, and realized a loss of $4.7 million, primarily from related transaction costs. Period to period comparisons of our other operating income may vary substantially, depending on the earnings generated by new transactions or investments, income or loss related to changes in the market values of certain investments, and gains or losses related to any disposition.

In 2009, we sold certain fixed income securities and realized a $12.1 million net gain, compared to a $16.8 million net realized loss on the sale of securities in 2008. We had $5.4 million of other-than-temporary impairment losses recorded through earnings in 2009, compared to $11.1 million of other-than-temporary impairment losses in 2008. There were no other-than-temporary impairment losses in 2007. See the Critical

Accounting Policies Other-than-temporary Impairments in Investments section below for additional discussion about our methodology for determining other-than temporary-impairment losses in all three years. Our net realized gain in 2007 included $13.4 million of embedded currency conversion gains on certain available for sale fixed income securities that we sold in December 2007. This realized gain was offset by a $13.4 million foreign currency loss recorded in other operating expense.

***Expenses***

We incur expenses for the following primary reasons:

- insurance claims paid or payable to policyholders, as well as expenses to adjust and settle the claims, and potential liability for incurred but not reported claims (collectively referred to as loss and loss adjustment expense ),
- direct policy acquisition costs, such as commissions, premium taxes and compensation of our underwriters,
- other operating expense, of which approximately 65% relates to compensation and benefits of our employees,
- interest expense on debt and short-term borrowings, and
- income taxes due to U.S. Federal, state, local and foreign jurisdictions.

Loss and loss adjustment expense was flat year-over-year in 2009 and increased 2% in 2008. The 2008 hurricanes increased the 2008 loss and loss adjustment expense by $19.4 million. Excluding the catastrophic hurricane losses, loss and loss adjustment expense was 2% higher in 2009 and 1% higher in 2008 compared to the respective prior year. Both years increased due to growth in net earned premium and were affected by changes in ultimate loss ratios and prior year redundant reserve development. Our loss ratio was 59.7% for 2009, compared to 60.4% for 2008 (which included 1.0 percentage point for the 2008 hurricanes) and 59.6% for 2007.

Policy acquisition costs decreased 5% in 2009 and increased 4% in 2008. In 2008, we recognized $3.8 million of expense to write off the deferred policy acquisition costs related to a line of business that had a premium deficiency reserve at December 31, 2008. These costs otherwise would have been expensed as policy acquisition costs in 2009. The 2009 decrease also was due to lower commission rates on certain lines of business and a change in the mix of business. The 2008 increase also was due to a change in the mix of business to lines with a lower loss ratio but higher expense ratio. See the Insurance Company Segment section below for additional discussion of the changes in our loss ratios by line of business and our policy acquisition costs.

Other operating expense, which includes compensation expense, increased 11% in 2009 and decreased 3% in 2008. Excluding the effect of the $13.4 million charge in 2007 that is described below, other operating expense increased 2% in 2008. The 2009 increase in other operating expense primarily was due to compensation and other operating expenses of businesses acquired in late 2008 and 2009, as well as higher bonus expense for profit-related bonus programs for our underwriters. In addition, the 2009 other operating expense included $9.9 million of expenses for costs directly related to the 2009 commutation of a reinsurance contract that had been accounted for using the deposit method of accounting. The 2009 other operating expense was partially offset by a $5.6 million benefit from the reversal of a reserve for uncollectible reinsurance for previously reserved recoverables that now are expected to be collected.

In 2007, we had a $13.4 million charge to correct the accounting for embedded currency conversion gains on certain fixed income securities classified as available for sale. Between 2005 and 2007, we used certain available for sale fixed income securities, denominated in British pound sterling, to economically hedge foreign currency exposure on certain insurance reserves and other liabilities, denominated in the same currency. We had incorrectly recorded the unrealized exchange rate fluctuations on these securities through earnings as an offset to the opposite fluctuations in the liabilities they hedged, rather than through other comprehensive income within shareholders equity. In 2007, to correct our accounting, we reversed

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$13.4 million of cumulative unrealized exchange rate gains. We recorded this reversal as a charge to our gain or loss from currency conversion account, with an offsetting credit to other comprehensive income. We reported our net loss from currency conversion, which included this $13.4 million charge, as a component of other operating expense in the consolidated statements of earnings. In 2007, we sold these available for sale securities and realized the $13.4 million of embedded cumulative currency conversion gains. This gain was included in the net realized investment gain (loss) line of our consolidated statements of earnings. The offsetting effect of these transactions had no impact on our 2007 consolidated net earnings. In 2008, we purchased a portfolio of bonds that we designated as held to maturity to economically hedge our foreign currency exposures. Our 2007 other operating expense also included professional fees and legal costs related to our 2006 stock option investigation.

Other operating expense includes $16.0 million, $13.7 million and $12.0 million in 2009, 2008 and 2007, 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. At December 31, 2009, there was approximately $22.9 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 2.6 years. In January 2010, we granted $12.2 million of restricted stock awards, with a weighted-average life of 7.9 years, to key employees. In 2010, we expect to recognize $13.2 million of compensation expense, including the amortization of deferred policy acquisition costs, for all stock-based awards outstanding at December 31, 2009 plus the newly-granted 2010 awards.

We had 1,864 employees at December 31, 2009 and 2008 and 1,685 employees at December 31, 2007. The number of new employees hired in 2009 was offset by the loss of employees due to the sale of two businesses in June and October 2009.

Interest expense decreased $4.2 million in 2009 and increased $4.1 million in 2008. During the three-year period until the fourth quarter of 2009, we had $124.7 million of 1.30% Convertible Notes outstanding and we borrowed and repaid our Revolving Loan Facility, as needed. The year-over-year changes in total interest expense primarily related to the borrowing levels on our Revolving Loan Facility. Interest on the facility was based on 30-day LIBOR (0.23%, 0.44% and 4.60% at December 31, 2009, 2008 and 2007, respectively) plus 25 basis points, but the effective interest on a portion of the facility was 4.60% due to interest rate swap agreements. In the fourth quarter of 2009, we issued $300.0 million of 6.30% Senior Notes due 2019, with an effective interest rate of 6.37%, and redeemed the Convertible Notes. Our 2009 interest expense includes $2.4 million for the Senior Notes. Our future annual interest expense on the Senior Notes will be approximately $19.0 million. See the Liquidity and Capital Resources section below for additional information about our debt structure.

Our effective income tax rate was 31.8% for 2009, compared to 30.1% for 2008 and 32.5% for 2007. The lower effective rate in 2008 related to the increased benefit from tax-exempt investment income relative to a lower pretax income base.

Total assets were $8.8 billion and shareholders equity was $3.0 billion, up from $8.3 billion and $2.6 billion, respectively, at December 31, 2008. Our book value per share was $26.58 at December 31, 2009, compared to $23.27 at December 31, 2008 and $21.24 at December 31, 2007. Our year-end 2009 consolidated shareholders equity benefited from an $89.7 million increase in the after-tax unrealized net investment gain related to our available for sale fixed income securities compared to year-end 2008. In 2008, our Board of Directors approved the repurchase of up to $100.0 million of our common stock. We repurchased 1.7 million shares for $35.5 million at a weighted-average cost of $21.36 per share in 2009 and 3.0 million shares for $63.3 million at a weighted-average cost of $21.02 per share in 2008. The impact of the share repurchases increased our book value per share by $0.22 in 2009 and $0.06 in 2008.

## Segments

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

***Insurance Company Segment***

Net earnings of our insurance company segment increased $60.8 million, or 20%, to $362.5 million in 2009 compared to $301.7 million in 2008 and $357.8 million in 2007. The 2009 increase resulted from: 1) higher premium volume, 2) the net impact of the commutation in 2009 of a reinsurance contract that had been accounted for using the deposit method of accounting and 3) higher investment income. The lower 2008 earnings were primarily due to alternative investment losses, net realized investment losses and the 2008 hurricane losses. Margins in our insurance companies remain at an acceptable level of profitability in 2009 even though there is pricing competition in certain of our markets.

**Premium**

Gross written premium increased 2% in each of the past two years to $2.6 billion in 2009 and $2.5 billion in 2008. Our net written premium in 2009 was essentially flat at $2.0 billion, while our net earned premium increased 1% to $2.0 billion. In 2008, net written premium increased 4% and net earned premium increased 1%. Our gross written premium grew in 2009 due to additional writings in our diversified financial products and London market account lines of business and in our recently acquired businesses, offset by lower writings of aviation business and the discontinuance, in 2008, of both an assumed quota share contract and our U.K. motor business. Premium increased in 2008 due to our 2008 acquisitions.

In both years, higher demand and increased prices in certain products moderated the effect of decreased writings and lower prices in lines impacted by competitive market pressures. We wrote more business in our diversified financial products lines, particularly in our directors and officers liability and credit businesses, as prices increased in late 2008 and the market reacted to financial issues with other insurance companies. We elected to write less premium in certain lines, such as domestic aviation, that were affected by competition. Net written premium decreased in 2009 because we elected to reinsure more directors and officers liability business and the cost for reinsurance in our London market account was higher. The overall percentage of retained premium, as measured as the percent of net written premium to gross written premium, decreased slightly to 80% in 2009 from 82% in 2008 and 81% in 2007.

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

| | 2009 | | 2008 | | 2007 | |
|---|---|---|---|---|---|---|
| | Amount | % | Amount | % | Amount | % |
| Direct | $ 2,308,667 | 90% | $ 2,156,613 | 86% | $ 2,000,552 | 82% |
| Reinsurance assumed | 251,124 | 10 | 342,150 | 14 | 450,627 | 18 |
| Gross written premium | 2,559,791 | 100 | 2,498,763 | 100 | 2,451,179 | 100 |
| Reinsurance ceded | (513,502) | (20) | (438,145) | (18) | (465,570) | (19) |
| Net written premium | 2,046,289 | 80 | 2,060,618 | 82 | 1,985,609 | 81 |
| Change in unearned premium | (9,054) | | (52,844) | (2) | (523) | |
| **Net earned premium** | $ 2,037,235 | 80% | $ 2,007,774 | 80% | $ 1,985,086 | 81% |

The following tables provide premium information by line of business and major product lines.

| | Gross Written Premium | Net Written Premium | NWP as% of GWP | Net Earned Premium |
|---|---|---|---|---|
| Year Ended December 31, 2009 | | | | |
| Diversified financial products | | | | |
| Directors and officers | $ 529,607 | $ 376,021 | 71% | $ 371,650 |
| Errors and omissions | 257,786 | 222,664 | 86 | 234,768 |
| Other professional liability | 81,222 | 58,815 | 72 | 39,123 |
| U.S. surety and credit | 203,522 | 189,208 | 93 | 182,627 |
| International surety and credit | 75,776 | 68,887 | 91 | 68,162 |
| | 1,147,913 | 915,595 | 80 | 896,330 |
| Group life, accident and health | | | | |
| Medical stop-loss | 633,573 | 633,571 | 100 | 633,572 |
| Other medical | 137,187 | 137,187 | 100 | 134,161 |
| Other | 75,281 | 26,020 | 35 | 29,887 |
| | 846,041 | 796,778 | 94 | 797,620 |
| Aviation | 176,073 | 124,336 | 71 | 129,626 |
| London market account | | | | |
| Energy | 98,934 | 49,452 | 50 | 49,116 |
| Other | 87,669 | 52,955 | 60 | 54,043 |
| | 186,603 | 102,407 | 55 | 103,159 |
| Other specialty lines | | | | |
| Public risk | 66,176 | 48,524 | 73 | 39,986 |
| HCC Lloyd s | 42,961 | 35,721 | 83 | 40,273 |
| Other | 93,872 | 22,802 | 24 | 30,114 |
| | 203,009 | 107,047 | 53 | 110,373 |
| Discontinued lines | 152 | 126 | nm | 127 |
| **Totals** | $ 2,559,791 | $ 2,046,289 | 80% | $ 2,037,235 |

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| | Gross Written Premium | Net Written Premium | NWP as% of GWP | Net Earned Premium |
|---|---|---|---|---|
| Year Ended December 31, 2008 | | | | |
| Diversified financial products | | | | |
| Directors and officers | $ 456,285 | $ 341,698 | 75% | $ 312,135 |
| Errors and omissions | 274,293 | 246,185 | 90 | 227,667 |
| Other professional liability | 62,585 | 42,686 | 68 | 31,753 |
| U.S. surety and credit | 183,384 | 175,533 | 96 | 167,914 |
| International surety and credit | 75,175 | 65,905 | 88 | 66,135 |
| | 1,051,722 | 872,007 | 83 | 805,604 |
| Group life, accident and health | | | | |
| Medical stop-loss | 616,878 | 616,878 | 100 | 616,900 |
| Other medical | 136,111 | 136,111 | 100 | 121,865 |
| Other | 76,914 | 36,490 | 47 | 38,503 |
| | 829,903 | 789,479 | 95 | 777,268 |
| Aviation | 185,786 | 136,019 | 73 | 139,838 |
| London market account | | | | |
| Energy | 97,334 | 57,913 | 59 | 57,262 |
| Other | 78,227 | 49,321 | 63 | 49,595 |
| | 175,561 | 107,234 | 61 | 106,857 |
| Other specialty lines | | | | |
| Public risk | 42,871 | 28,553 | 67 | 25,600 |
| HCC Lloyd s | 72,349 | 63,191 | 87 | 62,126 |
| Other | 135,801 | 59,376 | 44 | 85,723 |
| | 251,021 | 151,120 | 60 | 173,449 |
| Discontinued lines | 4,770 | 4,759 | nm | 4,758 |
| **Totals** | $ 2,498,763 | $ 2,060,618 | 82% | $ 2,007,774 |

| | Gross Written Premium | Net Written Premium | NWP as% of GWP | Net Earned Premium |
|---|---|---|---|---|
| Year Ended December 31, 2007 | | | | |
| Diversified financial products | | | | |
| Directors and officers | $ 395,084 | $ 296,955 | 75% | $ 326,099 |
| Errors and omissions | 274,131 | 216,382 | 79 | 223,566 |
| Other professional liability | 41,665 | 28,782 | 69 | 30,216 |
| U.S. surety and credit | 174,434 | 162,607 | 93 | 141,957 |
| International surety and credit | 78,041 | 66,922 | 86 | 55,576 |
| | 963,355 | 771,648 | 80 | 777,414 |
| Group life, accident and health | | | | |
| Medical stop-loss | 607,984 | 607,984 | 100 | 607,980 |
| Other medical | 110,593 | 110,593 | 100 | 110,593 |
| Other | 80,107 | 40,630 | 51 | 39,943 |
| | 798,684 | 759,207 | 95 | 758,516 |
| Aviation | 195,809 | 145,761 | 74 | 153,121 |
| London market account | | | | |
| Energy | 114,649 | 53,580 | 47 | 59,249 |
| Other | 99,067 | 64,661 | 65 | 65,360 |
| | 213,716 | 118,241 | 55 | 124,609 |
| Other specialty lines | | | | |
| Public risk | 33,302 | 22,085 | 66 | 17,414 |
| HCC Lloyd s | 73,648 | 67,874 | 92 | 56,032 |
| Other | 173,090 | 101,192 | 58 | 98,378 |
| | 280,040 | 191,151 | 68 | 171,824 |
| Discontinued lines | (425) | (399) | nm | (398) |
| **Totals** | $ 2,451,179 | $ 1,985,609 | 81% | $ 1,985,086 |

nm Not meaningful comparison

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

*Diversified financial products* Gross and net written premium increased in 2009 because we wrote more domestic directors and officers liability and credit business at higher prices in 2009. Our U.S. surety premium grew in 2009 due to an acquisition in early 2009. Premium volume in our other major products in this group was stable, although pricing for certain of these products is down slightly. Earned premium increased in 2009 primarily due to the higher volume of directors and officers liability business written in both 2009 and the last half of 2008. Our retention was lower in 2009 because we are reinsuring more directors and officers liability business.

Written premium increased in 2008 due to higher policy count and price increases in our directors and officers liability business, particularly for financial institution accounts, and in our U.S. credit business. In addition, increases in quota share retentions on employment practices liability business and some parts of our errors and omissions liability business increased the 2008 net written premium and retention rate. Premium volume of our other major products was stable in 2008, although pricing for certain products was down. During 2008, we also wrote three new products grouped in other professional liability.

*Group life, accident and health* Our medical stop-loss business grew in 2009 from a medical stop-loss agency acquired in late 2008. The 2009 increase in net earned premium and the 2008 increase in premium were due to our acquisition of an agency in early 2008, which writes short-term medical insurance using one of our managed Lloyd s syndicates as the issuing carrier. We retain most of our medical stop-loss and short-term medical business because the business traditionally has been non-volatile and has little catastrophic exposure.

*Aviation* We wrote less aviation business in 2009 and 2008 due to continuing competition on U.S. business and lack of growth in the general aviation industry. Pricing on this line remains competitive, although we saw price increases on the international portion of this business in 2009. Our underwriting margins on both U.S. and international business continue to be at expected levels.

*London market account* This line of business has the most exposure to catastrophic losses from hurricanes and earthquakes. Rates can change quickly, leading to higher premium volatility than our other lines of business. Gross written premium increased in 2009 due to writing more property business. Net written and net earned premium were lower in 2009 due to increased spending on reinsurance. Written premium decreased in 2008 due to increased competition and lower rates. Also, in 2008, we discontinued writing our marine excess of loss book of business due to unacceptable pricing. We expect premium volume to increase in 2010, as we recently hired an underwriting team to write property reinsurance.

*Other specialty lines* Premium in our public risk businesses increased in 2009 due to acquisitions in late 2008. Premium decreased in our HCC Lloyd s line in 2009 and 2008 due to discontinuance of our U.K. motor business in mid-2008. Premium also decreased in 2009 and 2008 due to expiration of an assumed quota share contract in the first half of 2008. The decrease in the retention percentages in 2009 and 2008 was due to the change in mix of business in this line.

**Reinsurance**

Annually, we analyze our threshold for risk in each line of business and on an overall consolidated basis, based on a number of factors, including market conditions, pricing, competition and the inherent risks associated with each business type, and then we structure our reinsurance programs. Based on our analysis of these factors, we may determine not to purchase reinsurance for some lines of business. We generally purchase reinsurance to reduce our net liability on individual risks and to protect against catastrophe losses and volatility. We retain underwriting risk in certain lines of business in order to retain a greater proportion of expected underwriting profits. We have chosen not to purchase any reinsurance on businesses where volatility or catastrophe risks are considered remote and limits are within our risk tolerance.

We purchase reinsurance on a proportional basis to cover loss frequency, individual risk severity and catastrophe exposure. Some of the proportional reinsurance agreements may have maximum loss limits, most of which are at or greater than a 200% loss ratio. We also purchase reinsurance on an excess of loss basis to cover individual risk severity and catastrophe exposure. Additionally, we may obtain facultative reinsurance protection on a single risk. The type and amount of reinsurance we purchase varies year to year based on our risk assessment, our desired retention levels based on profitability and other considerations, and on the market availability of quality reinsurance at prices we consider acceptable. Our reinsurance programs renew throughout the year, and the price changes in recent years have not been material to our net underwriting results. Our reinsurance generally does not cover war or terrorism risks, which are excluded from most of our policies.

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

Our Reinsurance Security Policy Committee carefully monitors the credit quality of the reinsurers with which we do business on all new and renewal reinsurance placements and on an ongoing, current basis. The Committee uses objective criteria to select and retain our reinsurers, which include requiring: 1) minimum surplus of $250 million, 2) minimum capacity of £100 million for Lloyd s syndicates, 3) financial strength rating of A− or better from A.M. Best Company, Inc. or Standard & Poor s Corporation, 4) an unqualified opinion on the reinsurer s financial statements from an independent audit, 5) approval from the reinsurance broker, if a party to the transaction, and 6) a minimum of five years in business for non-U.S. reinsurers. The Committee approves exceptions to these criteria when warranted. Our recoverables are due principally from highly-rated reinsurers.

Our reinsurance recoverables decreased in amount and as a percentage of our shareholders equity during 2009. The percentage of reinsurance recoverables compared to our shareholders equity was 34% and 40% at December 31, 2009 and 2008, respectively. In 2009, we collected certain reinsured losses from the 2008 hurricanes and several other large individual losses from 2008 that were highly reinsured. These reductions were partially offset by increased recoverables from our U.S. credit business and from our increased writings of directors and officers liability business in the past several years, where it takes longer for claims reserves to result in paid claims.

We continuously monitor our financial exposure to the reinsurance market and take necessary actions in an attempt to mitigate our exposure to possible loss. We have a reserve of $2.9 million at December 31, 2009 for potential collectability issues related to reinsurance recoverables, including disputed amounts and associated expenses. We review the level and adequacy of our reserve at each quarter-end. While we believe the year-end reserve is adequate based on information currently available, market conditions may change or additional information might be obtained that may require us to change the reserve in the future.

One of our insurance companies previously sold its entire block of individual life insurance and annuity business to Swiss Re Life & Health America, Inc. (rated A by A.M. Best Company, Inc.) in the form of an indemnity reinsurance contract. Ceded life and annuity benefits included in our consolidated balance sheets at December 31, 2009 and 2008, were $61.3 million and $64.2 million, respectively.

**Losses and Loss Adjustment Expenses**

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

| | 2009 | | 2008 | | 2007 | |
|---|---|---|---|---|---|---|
| | Amount | Loss Ratio | Amount | Loss Ratio | Amount | Loss Ratio |
| (Redundant) adverse development: | | | | | | |
| Discontinued accident and health adjustments | $ (1,244) | % | $ 34,148 | 1.4% | $ (46,531) | (1.9)% |
| Discontinued international medical malpractice adjustments | 5,561 | 0.2 | (536) | | 11,568 | 0.5 |
| Other reserve redundancies | (94,752) | (3.8) | (105,656) | (4.3) | (55,658) | (2.3) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total redundant development | (90,435) | (3.6) | (72,044) | (2.9) | (90,621) | (3.7) |
| 2008 hurricanes | | | 98,200 | 4.0 | | |
| All other gross incurred loss and loss adjustment expense | 1,579,331 | 62.8 | 1,609,338 | 65.5 | 1,443,031 | 59.2 |
| **Gross incurred loss and loss adjustment expense** | $ 1,488, 896 | 59.2% | $ 1,635,494 | 66.6% | $ 1,352,410 | 55.5% |

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Our gross redundant reserve development relating to prior years losses was $90.4 million in 2009, $72.0 million in 2008 and $90.6 million in 2007. The other reserve redundancies resulted primarily from our review and reduction of gross reserves where the anticipated development was considered to be less than the recorded reserves. Redundancies and deficiencies also occur as a result of claims being settled for amounts different from recorded reserves, or as claims exposures change. The other gross reserve redundancies in all three years related primarily to reserve reductions from the 2002 2006 underwriting years in: 1) our diversified financial products line of business, primarily in our directors and officers liability, U.K. professional indemnity and U.S. surety products, 2) our London market account, which includes redundancies on the 2005 hurricanes and 3) for an assumed quota share program in our other specialty line of business. These products, with a duration of either medium or medium to long tailed, were new products for us in 2002 2004. Because we lacked sufficient internal data, we used industry, prior carrier and/or ceding company information to estimate our ultimate incurred losses for these products. Our actual experience in subsequent years, as claims were reported and matured, was better than expected due, in part, to better than expected market conditions and lower than expected severity and frequency of claims. As part of our 2009 reserve review, we re-estimated our exposure in our directors and officers liability business, which resulted in redundant reserve development in the 2004 2006 underwriting years that was substantially offset by an increase in reserves for the 2007 underwriting year. As part of our 2008 reserve review, we also increased the accident year 2008 losses for our directors and officers liability business due to increased claims activity, primarily from financial institutions. The largest portion of this increase was for policies written in 2007.

Loss reserves on international medical malpractice business, in run-off since shortly after we acquired the subsidiary in 2002 that wrote this business, were strengthened in 2009 due to recent negative court rulings, and in 2007 in response to a deteriorating legal and settlement environment at that time. These claims, with a medium to long tailed duration, have had a higher than expected severity and frequency due to unexpected rulings by Spanish courts.

There were also redundancies in both 2009 and 2008 from the 2005 hurricanes. As reported losses are settled, in some cases for less than their initial reserves, the need for additional incurred but not reported reserves has diminished.

For certain run-off assumed accident and health reinsurance business that is reported in our discontinued lines of business, the gross (redundant) adverse development related to prior accident years has changed substantially year-over-year, as shown in the above table. The gross losses have fluctuated due to our processing of additional information received and our continuing evaluation of gross and net reserves related to this business. To establish our loss reserves, we consider a combination of factors including: 1) the nature of the business, which is primarily excess of loss reinsurance, 2) late reported losses by insureds, reinsureds and state guaranty associations and 3) changes in our actuarial assumptions to reflect additional information received during the year. The run-off assumed accident and health reinsurance business is primarily reinsurance that provides excess coverage for large losses related to workers compensation policies. This business is slow to develop and may take as many as twenty years to pay out. Losses in lower layers must develop first before our excess coverage attaches. Thus, the losses are reported to excess of loss reinsurers later in the life cycle of the claim. Compounding this late reporting is the fact that a number of large insurance companies that were cedants of this business failed and were taken over by state regulatory authorities in 2002 and 2003. The state guaranty associations covering these failed companies have been slow to report losses to us. At each quarter-end, we evaluate and consider all currently available information and adjust our gross and net reserves to amounts that management determines are appropriate to cover projected losses, given the risk inherent in this type of business. Because of substantial reinsurance, the net effect on our consolidated net earnings of the adjustments in each year has been much less than the gross effects shown above.

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

| | 2009 | | | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Amount | Loss Ratio | | Amount | Loss Ratio | | Amount | Loss Ratio | |
| (Redundant) adverse development: | | | | | | | | | |
| Discontinued accident and health commutations | $ | | % | $ | | % | $ 2,616 | 0.1 | % |
| Discontinued accident and health adjustments | 716 | | | 3,429 | 0.2 | | 376 | | |
| Discontinued international medical malpractice adjustments | 5,561 | 0.3 | | (526) | | | 11,568 | 0.6 | |
| Other reserve redundancies | (59,801) | (2.9) | | (85,274) | (4.2) | | (40,957) | (2.1) | |
| Total redundant development | (53,524) | (2.6) | | (82,371) | (4.0) | | (26,397) | (1.4) | |
| 2008 hurricanes | | | | 19,379 | 1.1 | | | | |
| All other net incurred loss and loss adjustment expense | 1,269,283 | 62.3 | | 1,274,865 | 63.3 | | 1,210,344 | 61.0 | |
| **Net incurred loss and loss adjustment expense** | $ 1,215,759 | 59.7 | % | $ 1,211,873 | 60.4 | % | $ 1,183,947 | 59.6 | % |

Our net redundant reserve development relating to prior years losses was $53.5 million in 2009, $82.4 million in 2008 and $26.4 million in 2007. The reasons for the net redundant development mirror the reasons described in the previous paragraphs for the gross redundant development. We believe we have provided for all material net incurred losses as of December 31, 2009.

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The following table provides comparative net loss ratios by line of business and major product lines.

| | 2009 | | 2008 | | 2007 | |
|---|---|---|---|---|---|---|
| | Net Earned Premium | Net Loss Ratio | Net Earned Premium | Net Loss Ratio | Net Earned Premium | Net Loss Ratio |
| Diversified financial products | | | | | | |
| Directors and officers | $ 371,650 | 61.2% | $ 312,135 | 59.0% | $ 326,099 | 45.4% |
| Errors and omissions | 234,768 | 49.6 | 227,667 | 50.0 | 223,566 | 48.4 |
| Other professional liability | 39,123 | 43.4 | 31,753 | 40.2 | 30,216 | 48.2 |
| U.S. surety and credit | 182,627 | 29.9 | 167,914 | 23.7 | 141,957 | 16.3 |
| International surety and credit | 68,162 | 50.9 | 66,135 | 56.1 | 55,576 | 38.5 |
| | 896,330 | 50.2 | 805,604 | 48.1 | 777,414 | 40.6 |
| Group life, accident and health | | | | | | |
| Medical stop-loss | 633,572 | 71.7 | 616,900 | 73.1 | 607,980 | 74.3 |
| Other medical | 134,161 | 86.0 | 121,865 | 80.9 | 110,593 | 95.1 |
| Other | 29,887 | 43.6 | 38,503 | 47.1 | 39,943 | 57.5 |
| | 797,620 | 73.0 | 777,268 | 73.1 | 758,516 | 76.4 |
| Aviation | 129,626 | 56.6 | 139,838 | 62.6 | 153,121 | 58.6 |
| London market account | | | | | | |
| Energy | 49,116 | 24.0 | 57,262 | 42.6 | 59,249 | 48.6 |
| Other | 54,043 | 41.5 | 49,595 | 50.8 | 65,360 | 61.2 |
| | 103,159 | 33.1 | 106,857 | 46.4 | 124,609 | 55.2 |
| Other specialty lines | | | | | | |
| Public risk | 39,986 | 66.3 | 25,600 | 72.3 | 17,414 | 66.9 |
| HCC Lloyd s | 40,273 | 69.1 | 62,126 | 78.3 | 56,032 | 78.0 |
| Other | 30,114 | 49.6 | 85,723 | 57.6 | 98,378 | 61.5 |
| | 110,373 | 62.8 | 173,449 | 67.2 | 171,824 | 67.4 |
| Discontinued lines | 127 | nm | 4,758 | nm | (398) | nm |
| **Totals** | $ 2,037,235 | 59.7% | $ 2,007,774 | 60.4% | $ 1,985,086 | 59.6% |
| **Expense ratio** | | 25.2 | | 25.0 | | 23.8 |
| **Combined ratio** | | 84.9% | | 85.4% | | 83.4% |

nm Not meaningful comparison since ratios relate to discontinued lines of business.

The change in net loss ratios between years resulted principally from the following factors:

*Diversified financial products* The total net loss ratios for this line of business reflect redundant net reserve development of $31.0 million in 2009, compared to $43.8 million in 2008 and $51.9 million in 2007. The 2009 and 2008 redundancies primarily related to our directors and officers liability and U.K. professional indemnity businesses for 2006 and prior underwriting years. The 2009 development included $70.3 million of additional loss reserves on our directors and officers liability business for policies written in 2007. Offsetting the redundant reserve development in 2008 was an increase of $50.1 million in our loss estimates on the 2008 accident year affecting business written in the 2007 and 2008 underwriting years, primarily for our directors and officers liability and credit businesses. Our U.S. surety business had favorable loss development in 2008 and 2007, but the 2009 accident year losses were higher than the 2008 accident year losses due to the impact of the current economic environment on the construction industry.

*Group life, accident and health* While the net loss ratio remained flat in 2009, the 2009 net loss ratios reflect lower losses on our medical stop-loss business, offset by adverse development and higher losses on short-term medical and other medical coverages. Compared to 2007, the 2008 net loss ratio reflects lower losses on business acquired through an acquisition in late 2006 as the business was re-underwritten. The 2007 loss ratio also included some adverse development from prior years losses.

*Aviation* Redundant development in 2009 was higher than in 2008, but was partially offset by higher accident year losses in 2009. The 2008 hurricanes increased the 2008 losses by $1.4 million and the 2008 loss ratio by 1.0 percentage point.

*London market account* The 2009 net loss ratios included $12.9 million of redundant reserve development, of which $12.7 million related to the 2005 hurricanes. The redundancy reduced the 2009 total net loss ratio by 12.5 percentage points. The 2008 hurricanes increased the 2008 losses by $12.1 million and the 2008 loss ratio by 11.3 percentage points. There was also $21.4 million of redundant reserve development in 2008, mostly from our property and energy businesses, which included a $5.4 million reduction of the 2005 hurricane losses. The loss ratio in 2007 was slightly higher than expected due to adverse development in our London accident and health and energy businesses.

*Other specialty lines* The 2009, 2008 and 2007 net loss ratios included $7.0 million, $8.7 million and $4.4 million, respectively, of redundant reserve development, primarily from an assumed quota share program. The 2008 hurricanes increased losses by $5.9 million and the 2008 loss ratio by 3.4 percentage points. We incurred larger than expected losses on our film completion and film production businesses in 2009 and on our U.K. motor business in 2008.

*Discontinued lines* This line of business was adversely affected in 2009 and 2007 by the strengthening of the net loss reserves on our international medical malpractice business.

The table below provides a reconciliation of our reserves for loss and loss adjustment expense payable (net of reinsurance ceded), the amount of our paid claims and our net paid loss ratios.

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Net reserves for loss and loss adjustment expense payable at beginning of year | $ 2,416,271 | $ 2,342,800 | $ 2,108,961 |
| Net reserve additions from acquired businesses | 36,522 | 29,053 | 742 |
| Foreign currency adjustment | 25,067 | (82,677) | 27,304 |
| Incurred loss and loss adjustment expense | 1,215,759 | 1,211,873 | 1,183,947 |
| Loss and loss adjustment expense payments | 1,137,779 | 1,084,778 | 978,154 |
| **Net reserves for loss and loss adjustment expense payable at end of year** | $ 2,555,840 | $ 2,416,271 | $ 2,342,800 |
| **Net paid loss ratio** | 55.8% | 54.0% | 49.3% |

The net paid loss ratio is the percentage of losses paid, net of reinsurance, divided by net earned premium for the year. The net paid loss ratio has increased due to a variety of factors. In 2009, we commuted certain loss reserves related to excess workers compensation business that is in runoff for $43.9 million. This commutation had no material effect on net earnings but increased our net paid loss ratio by 2.1 percentage points in 2009. In 2008, we experienced an increase in payments on certain lines of business due to shortening the required reporting period, bringing claims processing in-house and responding to faster reporting of claims by insureds.

### Policy Acquisition Costs

Policy acquisition costs, which are reported net of the related portion of commissions on reinsurance ceded, decreased to $364.0 million in 2009 from $381.4 million in 2008, which increased from $366.6 million in 2007. Policy acquisition costs as a percentage of net earned premium decreased to 17.9% in 2009, compared to 19.0% in 2008 and 18.5% in 2007. In 2008, we recognized $3.8 million of expense to write off the deferred policy acquisition costs related to a line of business that had a premium deficiency reserve at December 31, 2008. These costs otherwise would have been expensed as policy acquisition costs in 2009. In addition, fluctuations in the policy acquisition cost ratio year-over-year are due to lower commission rates on certain lines of business and a change in the mix of business. The GAAP expense ratio of 25.2% in 2009 compares to 25.0% in 2008 and 23.8% in 2007. The 2009 ratio is higher due to lower policy acquisition costs being offset by the negative effect of lower income from reinsurance overrides and profit commissions on quota share treaties.

### Statutory

Regulatory guidelines suggest that a property and casualty insurer s annual statutory gross written premium should not exceed 900% of its statutory policyholders surplus and net written premium should not exceed 300% of its statutory policyholders surplus. However, industry and rating agency guidelines place these ratios at 300% and 200%, respectively. Our property and casualty insurance companies have maintained premium to surplus ratios lower than such guidelines. For 2009, our statutory gross written premium to policyholders surplus was 112.1% and our statutory net written premium to policyholders surplus was 97.5%. At December 31, 2009, each of our domestic insurance companies total adjusted capital significantly exceeded the authorized control level risk-based capital level prescribed by the National Association of Insurance Commissioners.

***Agency Segment***

Revenue from our agency segment was $182.1 million in 2009, compared to $188.4 million in 2008 and $178.6 million in 2007. Revenue for 2009 included $5.0 million of fee and commission income related to the 2009 commutation of a reinsurance contract that had been accounted for using the deposit method of accounting. The decrease in 2009 revenue was due to the sales of our commercial marine agency business and our reinsurance broker during the year. The increase in 2008 was primarily due to underwriting agencies acquired in 2008.

Agency segment earnings decreased to $21.0 million in 2009 from $28.4 million in 2008 and $33.9 million in 2007. The agency segment has incurred higher interest expense and operating expense related to the acquired underwriting agencies, as well as expenses in 2009 directly related to the commutation of the reinsurance contract mentioned above. In addition, over the past three years, a higher percentage of business is being written directly by our insurance companies, rather than being underwritten on behalf of third party insurance companies by our underwriting agencies. The effect of this shift reduced fee and commission income in our agency segment, but added revenue and net earnings to our insurance company segment.

On June 30, 2009, we sold the assets and licensed the intangibles related to our commercial marine agency business. We entered into a five-year managing general underwriter agreement that allows the purchaser to write that same business utilizing policies issued by one of our insurance companies. We recognized an immaterial gain on the sale transaction. On October 3, 2009, we executed a contract to sell 100% of the stock of our reinsurance broker, Rattner Mackenzie Limited, to an affiliate of Marsh & McLennan Companies, Inc. (MMC). We also executed an agreement with MMC and its affiliates whereby our insurance companies and agencies will continue to utilize MMC and its affiliates to place certain of our reinsurance programs. We recognized a loss on the transaction of $4.7 million, which was included in the other operations segment. Together, in 2009, these two operations contributed 11% and 23% of our agency segment revenue and net earnings, respectively.

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***Other Operations Segment***

Our other operations segment generated revenue of $7.3 million in 2009 and 2008, compared to $38.9 million in 2007. Net earnings were $2.4 million, $2.2 million and $22.8 million in the respective years. Items impacting each year were as follows:

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Strategic investments | $ 4,538 | $ 12,218 | $ 27,627 |
| Trading securities | | (11,698) | 3,881 |
| Sale of subsidiary | (4,678) | | |
| Service fees | 3,818 | 3,985 | 2,384 |
| Other | 3,644 | 2,821 | 5,012 |
| **Total segment revenue** | $ 7,322 | $ 7,326 | $ 38,904 |

The significant drop in revenue and net earnings was due to losses on our trading securities in 2008 and lower gains on the sales of strategic investments. We held a trading portfolio that we began to liquidate in 2006 and completed in 2008. Before their sales in 2008, two remaining positions generated losses due to poor market conditions. We invested the proceeds from all of these sales in fixed income securities. We realized gains of $2.4 million, $9.2 million and $21.6 million from the sales of strategic investments in 2009, 2008 and 2007, respectively. We recognized a loss related to the sale of our reinsurance broker in 2009. Results of this segment may vary substantially period to period depending on our investment in or disposition of strategic investments.

**Liquidity and Capital Resources**

During 2008, there were significant disruptions in the world-wide and U.S. financial markets. A number of large financial institutions failed, received substantial capital infusions and loans from the U.S. and various other governments, or were merged into other companies. The market disruptions resulted in tightening of available sources of credit, increases in the cost of credit and significant liquidity concerns for many companies. Although these conditions continued throughout 2009, we have not been impacted in any material manner by these market conditions. We believe we currently have ample sources of liquidity at a reasonable cost based on the following:

We held $940.1 million of cash and liquid short-term investments at December 31, 2009, which was $415.3 million more than at December 31, 2008. We sold approximately $210.0 million of fixed income securities in the fourth quarter of 2009 and held the funds as short-term investments, pending reinvestment. In addition, we held cash to pay, among other items, $64.5 million of convertible notes in the process of redemption at year-end and $15.5 million for shareholder dividends, which we paid in 2010.

We have averaged over $580.0 million in cash from our operating activities, excluding commutations, during the three years ended December 31, 2009.

Our available for sale bond portfolio had a fair value of $4.5 billion at December 31, 2009, compared to $4.1 billion at December 31, 2008, and has an average rating of AA+. We intend to hold these securities until their maturity, but we would be able to sell securities to generate cash if the need arises; however, should we sell certain securities in the portfolio before their maturity, we cannot be assured that we would recoup the full reported fair value of the securities sold at the time of sale.

Our insurance companies have sufficient resources to pay potential claims in 2010. As shown in the Contractual Obligations section below, we project that our insurance companies will pay approximately $1.2 billion of claims in 2010 based on historical payment patterns and claims history. We project that they will collect approximately $314.7 million of reinsurance recoveries in 2010. These subsidiaries have a total $1.2 billion of cash, short-term investments, maturing bonds, and principal payments from asset-backed and mortgage-backed securities in 2010 that will be available to pay these

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expected claims. We project that there will be approximately $300 million of available cash flow to fund any additional claims payments, if needed, before consideration of expected cash flow from the insurance companies 2010 operations.

In November 2009, we used our Universal Shelf registration agreement to issue $300.0 million of unsecured 6.30% Senior Notes that are payable on November 15, 2019. The Senior Notes were priced at a discount of $1.5 million, for an effective interest rate of 6.37%. Our future interest expense will increase to approximately $19.0 million, compared to $16.1 million in 2009, which included $2.4 million for the Senior Notes. However, we were able to lock in long-term debt at a very favorable rate in a tight credit market.

We have a committed line of credit, led by Wells Fargo, through a syndicate group of banks. Our Revolving Loan Facility provides borrowing capacity to $575.0 million through December 2011 at a rate of 30-day LIBOR (0.23% at December 31, 2009) plus 25 basis points. After our long-term debt issuance discussed above, we repaid $335.0 million outstanding on the facility. We had no outstanding borrowings at December 31, 2009. We can draw against the Revolving Loan Facility any time at our request. If we do, we believe that the banks will be able and willing to perform on their commitments to us. The facility agreement had two restrictive financial covenants, with which we were in compliance at December 31, 2009.

We have a $152.0 million Standby Letter of Credit Facility that is used to guarantee our performance in two Lloyd s of London syndicates. We increased this Standby Letter of Credit Facility from $82.0 million at December 31, 2008 in anticipation of our writing more business through our Lloyd s syndicate in 2010.

In the fourth quarter of 2009, all of our 1.3% Convertible Notes were surrendered for redemption. We paid $60.1 million in December and $64.5 million in January 2010 to settle the principal amount. We issued 1.0 million shares of our common stock at an average conversion price of $27.96 per share to settle the premium on the notes.

Our domestic insurance subsidiaries have the ability to pay $217.8 million in dividends in 2010 to our holding company without obtaining special permission from state regulatory authorities. Our underwriting agencies have no restrictions on the amount of dividends that can be paid to our holding company. The holding company can utilize these dividends to pay down debt, pay dividends to shareholders, fund acquisitions, repurchase common stock and pay operating expenses. Cash flow available to the holding company in 2010, together with cash held at year-end 2009, is expected to be sufficient to cover the holding company s required cash disbursements.

Our debt to total capital ratio was 9.0% at December 31, 2009 and 11.5% at December 31, 2008, and our fixed charge coverage ratio was 25.13 for 2009. We have a Universal Shelf registration agreement that provides for the issuance of an aggregate of $1.0 billion of securities, of which we have $700.0 million of remaining capacity. These securities may be debt securities, equity securities, trust preferred securities, or a combination thereof. The shelf registration provides us the means to access the debt and equity markets relatively quickly if we are satisfied with current pricing.

***Cash Flow***

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

Cash provided by operating activities can fluctuate due to timing differences in the collection of premiums and reinsurance recoverables and the payment of losses and premium and reinsurance balances payable and the completion of commutations. Our operating cash flow also exceeds our net earnings due to expansion of our diversified financial products line of business, where we retain premium for a longer duration and pay claims later than for our short-tailed business.

We generated cash from operations of $582.8 million in 2009, $506.0 million in 2008 and $726.4 million in 2007. The components of our net operating cash flows are summarized in the following table.

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Net earnings | $ 353,868 | $ 302,120 | $ 391,553 |
| Change in premium, claims and other receivables, net of reinsurance, other payables and restricted cash | (15,186) | (41,248) | (60,671) |
| Change in unearned premium, net | 14,259 | 43,835 | 3,062 |
| Change in loss and loss adjustment expense payable, net of reinsurance recoverables | 64,960 | 89,910 | 342,556 |
| Change in trading securities | | 49,091 | 9,362 |
| (Gain) loss on investments | (3,518) | 49,549 | (58,736) |
| Other, net | 168,414 | 12,711 | 99,310 |
| **Cash provided by operating activities** | $ 582,797 | $ 505,968 | $ 726,436 |

Cash provided by operating activities increased $76.8 million in 2009 and decreased $220.5 million in 2008. In 2009, we paid $43.9 million of cash for an inward commutation of certain loss reserves, which reduced our 2009 cash provided by operating activities. In 2008 and 2007, we received $7.5 million and $101.0 million, respectively, of cash from outward commutations, which increased our cash provided by operating activities. Excluding the commutations, cash provided by operating activities was $626.7 million in 2009, $498.5 million in 2008 and $625.4 million in 2007.

In 2009, we received special cash receipts of: 1) $25.0 million to commute a reinsurance contract that had been accounted for using the deposit method of accounting and 2) $20.3 million to partially liquidate a receivable related to a derivative financial instrument. In addition, fiduciary funds, for which we earn the interest income, increased $91.0 million in 2009. The decrease in 2008 primarily resulted from a decrease in net earnings, as well as the timing of the collection of reinsurance recoverables and the payment of insurance claims. We collected more cash from reinsurers in early 2007 than in 2008 as a result of reimbursement of 2005 hurricane claims that we had paid in late 2006.

***Investments***

Our investment policy is determined by our Board of Directors and our Investment and Finance Committee and is reviewed on a regular basis. We engage an independent investment advisor to oversee our investments, based on the investment policies promulgated by our Investment and Finance Committee, and to make investment recommendations. The majority of our investment assets are held by our insurance companies. The investment policy for each of our domestic insurance company subsidiaries must comply with applicable state and Federal regulations that prescribe the type, quality and concentration of investments. These regulations permit investments, within specified limits and subject to certain qualifications, in U.S. government, state and municipal obligations, corporate bonds, obligations of foreign countries, and preferred and common equity securities. The regulations generally allow certain other types of investments subject to maximum limitations. Investments of our foreign insurance companies must comply with the regulations of their country of domicile.

At December 31, 2009, we had $5.5 billion of total investments, an increase of $651.9 million from December 31, 2008. The increase resulted principally from our operating cash flows, a $141.7 million increase in the fair value of our available for sale fixed income securities, and $52.6 million of proceeds from redemption of our alternative investments, which were recorded as a receivable at year-end 2008. We redeemed all of our alternative investments in 2008 and reinvested the $94.1 million of proceeds in fixed income securities. We held $810.7 million of short-term investments at year-end 2009, which is higher than our normal level, because we liquidated certain fixed income securities in the fourth quarter and the funds were pending reinvestment.

We invest substantially all of our funds in highly-rated fixed income securities, the majority of which are designated as available for sale securities. We held $4.6 billion and $4.3 billion of fixed income securities at December 31, 2009 and 2008, respectively. At year-end 2009, 99% of our fixed income securities were investment grade, of which 83% were rated AAA or AA. The portfolio has a weighted-average maturity of 6.5 years and a weighted-average duration of 4.9 years.

The fair value of our fixed income securities fluctuates depending on general economic and market conditions. As market interest rates increase, the fair value will generally decrease, and as market interest rates decrease, the fair value will generally increase. At December 31, 2009, the net unrealized gain on our available for sale fixed income securities portfolio was $156.3 million, compared to $14.6 million at December 31, 2008. The change in the net unrealized gain or loss, net of the related income tax effect, is recorded in other comprehensive income and fluctuates with changes in market interest rates. Our general policy has been to hold our available for sale fixed income securities through periods of fluctuating interest rates.

A security has an impairment loss when its fair value is less than its cost or amortized cost at the balance sheet date. The gross unrealized losses of individual securities within our available for sale fixed income securities was $18.9 million at December 31, 2009 and $91.3 million at December 31, 2008. We evaluate the securities in our fixed income securities portfolio for possible other-than-temporary impairment losses at each quarter end. See the Critical Accounting Policies Other-than-temporary Impairments in Investments section below for a description of the accounting policies and procedures that we use to determine our other-than-temporary impairment losses. Over the three-year period of 2007 2009, we realized only $16.6 million of other-than-temporary impairment losses through pretax earnings, of which $5.4 million were in 2009 and $11.1 million were in 2008.

In 2008, we began holding certain bonds in a held to maturity portfolio. This portfolio includes securities, denominated in currencies other than the functional currency of the subsidiary, for which we have the ability and intent to hold the securities to maturity or redemption. We hold these securities to hedge the foreign exchange risk associated with insurance claims that we will pay in foreign currencies. The amortized cost of bonds in our held to maturity portfolio was $102.8 million at December 31, 2009 and $123.6 million at December 31, 2008. Any foreign exchange gain/loss on these bonds will be recorded through income and will substantially offset any foreign exchange gain/loss on the related liabilities. Conversely, the foreign exchange gain/loss on our available for sale securities is recorded as a component of accumulated other comprehensive income within shareholders equity until the related bonds mature or are sold and, for accounting purposes, does not offset the opposite foreign currency movement on the hedged liabilities that is recorded through income.

Our historical investment strategy has been to maximize interest income and yield, within our risk tolerance, rather than to maximize total return. The average long-term tax equivalent yield of our fixed income securities portfolio was 5.1%, 5.2% and 5.4% in 2009, 2008 and 2007, respectively. Our investment portfolio turnover will fluctuate, depending upon investment opportunities. Realized gains and losses from sales of securities are usually minimal, unless we sell securities for investee credit-related reasons, or because we can reinvest the proceeds at a higher effective yield. We recognized net realized investment gains (losses) of $12.1 million, $(16.8) million and $13.2 million in 2009, 2008 and 2007, respectively.

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This table summarizes our investments by type, substantially all of which are reported at fair value, at December 31, 2009 and 2008.

| | December 31, | | | |
|---|---|---|---|---|
| | 2009 | | 2008 | |
| | Amount | % | Amount | % |
| Short-term investments | $ 810,673 | 15% | $ 497,477 | 10% |
| U.S. government and government agency securities | 328,535 | 6 | 227,607 | 5 |
| Fixed income securities of states, municipalities and political subdivisions | 1,059,426 | 19 | 1,091,903 | 23 |
| Special purpose revenue bonds of states, municipalities and political subdivisions | 1,146,334 | 21 | 899,632 | 19 |
| Corporate fixed income securities | 559,824 | 10 | 511,638 | 11 |
| Residential mortgage-backed securities | 944,182 | 17 | 823,078 | 17 |
| Commercial mortgage-backed securities | 146,217 | 3 | 151,836 | 3 |
| Asset-backed securities | 14,365 | | 65,952 | 1 |
| Foreign government securities | 307,891 | 6 | 333,365 | 7 |
| Foreign non-government securities | 134,091 | 3 | 151,707 | 3 |
| Other investments | 4,691 | | 50,088 | 1 |
| **Total investments** | $ 5,456,229 | 100% | $ 4,804,283 | 100% |

This table shows the average amount of investments, net income earned, related yields and duration, and average rating of our fixed income securities.

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| Average investments, at cost | $ 5,071,688 | $ 4,627,484 | $ 4,126,644 |
| Net investment income* | 191,965 | 164,751 | 206,462 |
| Average short-term yield* | 0.5% | 3.8% | 5.2% |
| Average long-term yield* | 4.2% | 4.4% | 4.5% |
| Average long-term tax equivalent yield* | 5.1% | 5.2% | 5.4% |
| Average combined tax equivalent yield* | 4.5% | 4.2% | 5.6% |
| Weighted-average maturity of fixed income securities | 6.5 years | 6.0 years | 7.0 years |
| Weighted-average duration of fixed income securities | 4.9 years | 4.8 years | 4.9 years |
| Weighted-average combined duration | 4.2 years | 4.3 years | 4.2 years |
| Average rating of fixed income securities | AA+ | AA+ | AAA |

* Excluding realized and unrealized investment gains and losses.

This table summarizes our investments in fixed income securities by their rating category at December 31, 2009.

| | Available for Sale | Held to Maturity |
|---|---|---|

| | Fair Value Amount | % | Amortized Cost Amount | % |
|---|---|---|---|---|
| AAA | $ 2,176,909 | 48% | $ 102,792 | 100% |
| AA | 1,556,500 | 34 | | |
| A | 662,617 | 15 | | |
| BBB | 108,318 | 2 | | |
| BB and below | 33,729 | 1 | | |
| **Total fixed income securities** | $ 4,538,073 | 100% | $ 102,792 | 100% |

The overall rating of our municipal bonds (consisting of our fixed income securities of states, municipalities and political subdivisions and our special purpose revenue bonds of states, municipalities and political subdivisions) was AA at December 31, 2009. Our portfolio of special purpose revenue bonds at December 31, 2009 and 2008 included $138.7 million and $150.9 million, respectively, of pre-refunded bonds that are supported by U.S. government debt obligations. The remaining special purpose bonds are secured by revenue sources specific to each security, such as water, sewer and utility fees; highway tolls; airport usage fees; property, sales and fuel taxes; college tuition and services fees; and lease income. The table below summarizes our percentage holdings of special purpose revenue bonds by revenue source at December 31, 2009 and 2008.

| | December 31, | |
|---|---|---|
| | **2009** | **2008** |
| Water and sewer | 27% | 26% |
| Transportation | 13 | 14 |
| Education | 14 | 11 |
| Pre-refunded | 13 | 17 |
| Special tax | 11 | 13 |
| Leasing | 8 | 9 |
| Other | 14 | 10 |
| **Total** | 100% | 100% |

Many of our special purpose revenue bonds are insured by mono-line insurance companies or supported by credit enhancement programs of various states and municipalities. We view bond insurance as credit enhancement and not credit substitution. We base our investment decision on the strength of the issuer. A credit review is performed on each issuer and on the sustainability of the revenue source before we acquire a special purpose revenue bond and periodically, on an ongoing basis, thereafter. The underlying average credit rating of our special purpose revenue bond issuers, excluding any bond insurance, was AA at December 31, 2009. Although recent economic conditions in the United States may reduce the source of revenue for certain of these securities, the majority are supported by revenue from essential sources, such as water and sewer, education and transportation fees, which we believe generate a stable source of revenue.

At December 31, 2009, we held a corporate bond portfolio with a fair value of $559.8 million, an overall rating of A, and a weighted-average life of approximately 3.0 years. We also held a portfolio of residential mortgage-backed securities (MBSs) and collateralized mortgage obligations (CMOs) with a fair value of $944.2 million. Within our residential MBS/CMO portfolio, $887.6 million of securities, or 94%, were issued by the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which are backed by the U.S. government.

Within our residential mortgage-backed and asset-backed securities, we held bonds that are collateralized by prime, Alt A and subprime mortgages. All of these securities were current as to principal and interest. Details of these securities at December 31, 2009 were as follows:

| | **Fair Value** | **Average Rating** | **Weighted-Average Life** |
|---|---|---|---|
| Prime | $ 52,495 | BBB+ | 1.7 years |

| | | | |
|---|---|---|---|
| Alt A | 4,091 | BBB- | 3.2 years |
| Subprime | 1,547 | A+ | 5.8 years |

At December 31, 2009, we held a commercial MBS securities portfolio with a fair value of $146.2 million, an average rating of AAA, an average loan-to-value ratio of 69%, and a weighted-average life of approximately 4.7 years. We owned no collateralized debt obligations (CDOs) or collateralized loan obligations (CLOs), and we have never been counterparty to any credit default swap transactions.

This table indicates the expected maturity distribution of our fixed income securities at December 31, 2009.

| | Available for Sale Amortized Cost Amount | % | Asset-Backed and Mortgage-Backed Amortized Cost Amount | % | Held to Maturity Amortized Cost Amount | % | Total Fixed Income Securities Amount | % |
|---|---|---|---|---|---|---|---|---|
| One year or less | $ 277,943 | 8% | $ 274,538 | 25% | $ 27,692 | 27% | $ 580,173 | 13% |
| One year to five years | 1,103,086 | 34 | 807,140 | 75 | 67,789 | 66 | 1,978,015 | 44 |
| Five years to ten years | 800,382 | 24 | | | 7,311 | 7 | 807,693 | 18 |
| Ten years to fifteen years | 574,001 | 17 | | | | | 574,001 | 13 |
| More than fifteen years | 544,672 | 17 | | | | | 544,672 | 12 |
| **Total fixed income securities** | $ 3,300,084 | 100% | $ 1,081,678 | 100% | $ 102,792 | 100% | $ 4,484,554 | 100% |

The weighted-average life of our asset-backed and mortgage-backed securities is approximately 3.9 years based on expected future cash flows. In the table above, we allocated the maturities of asset-backed maturities and mortgage-backed securities based on the expected future principal payments.

Some of our fixed income securities have call or prepayment options. In addition, mortgage-backed and certain asset-backed securities have prepayment, extension or other market-related credit risk. Calls and prepayments subject us to reinvestment risk should interest rates fall and issuers call their securities and we reinvest the proceeds at lower interest rates. Prepayment risk exists if cash flows from the repayment of principal occurs earlier than anticipated because of declining interest rates. Extension risk exists if cash flows from the repayment of principal occurs later than anticipated because of rising interest rates. Credit risk exists if mortgagees default on the underlying mortgages. Net investment income and/or cash flows from investments that have call or prepayment options and prepayment, extension or credit risk may differ from what was anticipated at the time of investment. We mitigate these risks by investing in investment grade securities with varied maturity dates so that only a portion of our portfolio will mature at any point in time.

The fair value of our fixed income securities is sensitive to changing interest rates. As interest rates increase, the fair value will generally decrease, and as interest rates decrease, the fair value will generally increase. The fluctuations in fair value are somewhat muted by the relatively short duration of our portfolio and our relatively high level of investments in state and municipal obligations. We estimate that a 1% increase in market interest rates would decrease the fair value of our fixed income securities by approximately $230.0 million before tax and a 1% decrease in market interest rates would increase the fair value by a like amount. Fluctuations in interest rates have a minimal effect on the value of our short-term investments due to their very short maturities. Higher interest rates would have a positive effect on net earnings and lower interest rates would have a negative effect on net earnings.

***Fair Value***

We value financial assets and financial liabilities at fair value. In determining fair value, we generally apply the market approach, which uses prices and other relevant data based on market transactions involving identical or comparable assets and liabilities. We classify our financial instruments into the following three-level hierarchy:

Level 1 Inputs are based on quoted prices in active markets for identical instruments.

Level 2 Inputs are based on observable market data (other than quoted prices), or are derived from or corroborated by observable market data.

Level 3 Inputs are unobservable and not corroborated by market data.

Our Level 1 investments are primarily U.S. Treasuries listed on stock exchanges. At December 31, 2009 and 2008, our Level 1 investments totaled $178.9 million and $87.7 million and represented 4% and 2% of our total assets measured at fair value, respectively. We use quoted prices for identical instruments to measure fair value.

Our Level 2 investments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities, and certain mortgage-backed and asset-backed securities. At December 31, 2009 and 2008, our Level 2 investments totaled $4.4 billion and $4.0 billion and represented 96% and 97% of our total assets measured at fair value, respectively. Our Level 2 instruments also include our interest rate swap agreements, which were reflected as liabilities valued at $2.4 million and $8.0 million in our consolidated balance sheets at December 31, 2009 and 2008. We measure fair value for the majority of our Level 2 investments using quoted prices of securities with similar characteristics. The remaining investments are valued using pricing models or matrix pricing. The fair value measurements consider observable assumptions, including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, default rates, loss severity and other economic measures.

We use independent pricing services to assist us in determining fair value for over 99% of our Level 1 and Level 2 investments. The pricing services provide a single price or quote per security. We use data provided by our third party investment manager to value the remaining Level 2 investments. To validate that these quoted and modeled prices are reasonable estimates of fair value, we perform various quantitative and qualitative procedures, including:
1) evaluation of the underlying methodologies, 2) analysis of recent sales activity, 3) analytical review of our fair values against current market prices, and 4) comparison of the pricing services fair value to other pricing services fair value for the same investment. Based on these procedures, we did not adjust the prices or quotes provided by our independent pricing services or third party investment managers as of December 31, 2009 or 2008. In addition, we did not apply new accounting guidance issued in 2008 and 2009 for determining the fair value of securities in inactive markets since no markets for our investments were judged to be inactive as of December 31, 2009 and 2008.

Our Level 3 securities include certain fixed income securities and two insurance contracts that we account for as derivative financial instruments. At December 31, 2009 and 2008, our Level 3 investments totaled $4.7 million and $22.6 million, respectively, and represented less than 1% of our total assets measured at fair value. We determine fair value based on internally developed models that use assumptions or other data that are not readily observable from objective sources. Because we use the lowest level significant input to determine our hierarchy classifications, a financial instrument may be classified in Level 3 even though there may be significant readily-observable inputs. Our exposure with respect to the two insurance contracts is measured based on movement in a specified U.K. housing index. We determine their fair value based on our estimate of the present value of expected future cash flows, modified to reflect specific contract terms. In 2009, we collected $20.3 million to partially liquidate a receivable related to these contracts, which reduced the Level 3 value to $0.4 million at December 31, 2009. The remaining Level 3 value at year-end 2009 related to four commercial mortgage-backed and asset-backed securities. Transfers of investments into Level 3 occur due to our inability to obtain a fair value using inputs based on observable market data. Transfers of investments out of Level 3 occur because we were able to determine their fair value using inputs based on observable market data. Transfers in totaled $6.3 million and transfers out totaled $8.0 million in 2009.

See Note 2 to the Consolidated Financial Statements for tables that detail our assets and liabilities measured at fair value at December 31, 2009 and 2008, and the changes in our Level 3 category during 2009 and 2008. We excluded from our fair value disclosures our held to maturity investment portfolio measured at amortized cost and two other investments measured at cost. Our held to maturity portfolio had a fair value of $104.0 million at December 31, 2009 and $125.6 million at December 31, 2008. The two other investments collectively were valued at $4.1 million at December 31, 2009 and 2008.

***Contractual Obligations***

The following table summarizes our total contractual cash payment obligations by estimated payment date at December 31, 2009.

| | | | Estimated Payment Dates | | |
|---|---|---|---|---|---|
| | **Total** | **2010** | **2011-2012** | **2013-2014** | **Thereafter** |
| Gross loss and loss adjustment expense payable(1): | | | | | |
| Diversified financial products | $ 1,953,555 | $ 544,231 | $ 699,977 | $ 305,765 | $ 403,582 |
| Group life, accident and health | 309,610 | 256,655 | 44,484 | 7,137 | 1,334 |
| Aviation | 126,826 | 55,901 | 45,265 | 15,526 | 10,134 |
| London market account | 259,271 | 123,415 | 108,084 | 23,279 | 4,493 |
| Other specialty lines | 447,646 | 153,677 | 179,092 | 74,782 | 40,095 |
| Discontinued lines | 395,401 | 54,873 | 81,815 | 74,931 | 183,782 |
| Total loss and loss adjustment expense payable | 3,492,309 | 1,188,752 | 1,158,717 | 501,420 | 643,420 |
| Life and annuity policy benefits | 61,313 | 2,214 | 4,188 | 3,888 | 51,023 |
| 6.30% Senior Notes(2) | 489,000 | 18,900 | 37,800 | 37,800 | 394,500 |
| 1.30% Convertible Notes in process of conversion(3) | 64,472 | 64,472 | | | |
| $575.0 million Revolving Loan Facility(4) | 1,131 | 575 | 556 | | |
| Interest rate swaps(5) | 2,608 | 2,608 | | | |
| Operating leases | 69,172 | 14,089 | 22,701 | 15,689 | 16,693 |
| Earnout liabilities | 62,683 | 38,280 | 24,403 | | |
| Indemnifications | 12,842 | 3,273 | 4,989 | 3,617 | 963 |
| **Total obligations** | $ 4,255,530 | $ 1,333,163 | $ 1,253,354 | $ 562,414 | $ 1,106,599 |

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

(1) The estimated loss and loss adjustment expense payments for future periods assume that the percentage of ultimate losses paid from one period to the next by line of business will be relatively consistent over time. Actual payments will be influenced by many factors and could vary from the estimated amounts.

(2) The 6.30% Senior Notes are due in 2019. We pay interest semi-annually on May 15 and November 15, which is included in the above table.

(3) We redeemed our 1.30% Convertible Notes in November 2009 and paid cash to settle the remaining liability in January 2010.

(4) The $575.0 million Revolving Loan Facility expires on December 19, 2011. At December 31, 2009, there were no outstanding borrowings on the facility, but we pay an annual commitment fee of 10.0 basis points, which is included in the above table.

(5) Our interest rate swaps have a notional amount of $105.0 million and expire in November 2010. Under the terms of the swap agreements, we pay 2.94% and receive 30-day LIBOR (0.23% at December 31, 2009), the net of which is included in the above table.

**Claims Payments**

The following table compares our insurance company subsidiaries cash and investment maturities with their estimated future claims payments, net of reinsurance, at December 31, 2009.

| | | Maturities/Estimated Payment Dates | | | |
|---|---|---|---|---|---|
| | **Total** | **2010** | **2011-2012** | **2013-2014** | **Thereafter** |
| Cash and investment maturities of insurance companies | $ 5,228,647 | $ 1,172,835 | $ 1,263,463 | $ 785,583 | $ 2,006,766 |
| Estimated loss and loss adjustment expense payments, net of reinsurance | 2,555,840 | 874,044 | 814,180 | 373,449 | 494,167 |
| **Estimated available cash flow** | $ 2,672,807 | $ 298,791 | $ 449,283 | $ 412,134 | $ 1,512,599 |

The average duration of claims in many of our lines of business is relatively short, and, accordingly, our investment portfolio has a relatively short duration. The weighted-average duration of all claims was approximately 2.7 years in 2009 and 2.5 years in 2008 and 2007. The weighted-average duration of our fixed income securities was 4.9 years, 4.8 years and 4.9 years in 2009, 2008 and 2007, respectively. The longer duration of our fixed income securities reflects the effects of the investment of our capital. In recent years, we have expanded the directors and officers liability and errors and omissions liability components of our diversified financial products line of business, which have a longer claims duration than our other lines of business. We consider these different claims payment patterns in determining the duration of our investment portfolio.

We maintain sufficient liquidity from our current cash, short-term investments and investment maturities, in combination with future operating cash flow, to pay anticipated policyholder claims on their expected payment dates. We manage the liquidity of our insurance company subsidiaries such that each subsidiary s anticipated claims payments will be met by its own current operating cash flows, cash, short-term investments or investment maturities. We do not foresee the need to sell securities prior to their maturity to fund claims payments.

**Senior Notes**

On November 10, 2009, we issued $300.0 million of 6.30% Senior Notes due 2019. The Senior Notes were priced at a discount of $1.5 million, for an effective interest rate of 6.37%. Interest is due semi-annually in arrears on May 15 and November 15 of each year. The Senior Notes are unsecured and subordinated general obligations of HCC Insurance Holdings, Inc., the parent holding company. The Senior Notes rank junior to any secured indebtedness and to all existing and future liabilities of our subsidiaries, including amounts owed to policyholders. We can redeem the notes in whole at any time or in part from time to time, at our option, at the redemption price determined in the manner described in the indenture governing the notes. The indenture contains covenants that impose conditions on our ability to create liens on any capital stock of our restricted subsidiaries (as defined in the indenture) or to engage in sales of the capital stock of our restricted subsidiaries. We were in compliance with the requirements of the indenture at December 31, 2009.

**Convertible Notes**

The terms of the 1.30% Convertible Notes provided that we could redeem the notes for cash anytime after April 4, 2009 by giving the holders 30 days notice. On November 20, 2009, we announced our intention to redeem all of the notes within the next 30 days. As a result, substantially all of the holders surrendered their notes for conversion before the redemption date. We redeemed the unsurrendered notes according to their terms by December 31, 2009. For conversion, we paid cash for the principal amount of the notes and issued our common stock for the value of the conversion premium. The premium was based on the weighted-average closing price of our stock for the ten trading days after conversion. The average conversion price was $27.96 per share. At December 31, 2009, all of the notes had been surrendered, but some had not yet been settled because the ten-day period had not expired. We paid $60.2 million principal as of December 31, 2009, with the remaining $64.5 million principal paid in January 2010. We classified the unpaid amount as accounts

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payable and accrued liabilities in the consolidated balance sheet at December 31, 2009. We issued 1.0 million shares of our common stock in conjunction with the conversion.

**Revolving Loan Facility**

Our $575.0 million Revolving Loan Facility allows us to borrow up to the maximum allowed by the facility on a revolving basis until the facility expires on December 19, 2011. In 2009, we repaid the $335.0 million outstanding balance with proceeds from our Senior Notes and other sources of cash. There were no outstanding borrowings at December 31, 2009. The interest rate on any borrowings is 30-day LIBOR (0.23% at December 31, 2009) plus 25 basis points. We pay an annual commitment fee of 10 basis points.

During 2009, we paid interest on the Revolving Loan Facility at a weighted-average rate of 0.44%. We had interest rate swap agreements, discussed below, that converted the effective interest rate on $200.0 million of the facility to a fixed rate of 4.6%. In addition, we paid a commitment fee of 10.0 basis points. The facility is collateralized by guarantees entered into by our domestic underwriting agencies and contains two restrictive financial covenants, with which we were in compliance at December 31, 2009.

At December 31, 2008, we had three interest rate swap agreements to exchange 30-day LIBOR (0.44% at December 31, 2008) for a 4.60% fixed rate on $200.0 million of our Revolving Loan Facility. The swaps qualified for cash flow hedge accounting treatment. The three swaps expired in November 2009. As of December 31, 2008, we had entered into two additional swaps for $105.0 million, which began when the original swaps expired and will expire in November 2010. These swaps were entered into with a future effective date to minimize our exposure to expected interest rate increases due to the credit and market conditions in 2008. The fixed rate on these swaps is 2.94%, and they were in a total unrealized loss position of $2.4 million at December 31, 2009. These swaps do not qualify for hedge accounting treatment and the change in value is reported in our consolidated statements of earnings.

**Standby Letter of Credit Facility**

We have a $152.0 million Standby Letter of Credit Facility, increased from $82.0 million at December 31, 2008, that is used to guarantee our performance in two Lloyd s of London syndicates. Letters of credit issued under the Standby Letter of Credit Facility are unsecured commitments of HCC. The Standby Letter of Credit Facility contains the same two restrictive financial covenants as our Revolving Loan Facility, with which we were in compliance at December 31, 2009.

**Subsidiary Letters of Credit**

At December 31, 2009, certain of our subsidiaries had outstanding letters of credit with banks totaling $22.3 million, which were secured by fixed income securities with a fair value of $26.3 million.

**Earnouts**

Our prior acquisition of HCC Global Financial Products includes a contingency for future earnout payments, as defined in the purchase agreement, as amended. The earnout is based on HCC Global s pretax earnings from the acquisition date through September 30, 2007, with no maximum amount due to the former owners. Pretax earnings include underwriting results on longer-duration business until all future losses are paid. When conditions specified under the purchase agreement are met, we record a net liability for amounts owed to or due from the former owners based on our estimate at that point in time of potential future losses. This net liability will fluctuate in the future, and the ultimate total earnout payments cannot be finally determined, until all claims are paid. We accrued a net liability of $18.0 million at December 31, 2009, with an offset to goodwill. Accrued amounts are paid according to contractual requirements in the purchase agreement, with $38.3 million due to the former owners in 2010.

Our 2008 acquisition of HCC Medical Insurance Services includes an earnout based on achievement of certain underwriting profit levels. At December 31, 2009, the accrued earnout, which will be paid in 2011, totaled $1.7 million.

### Indemnifications

In conjunction with the sales of business assets and subsidiaries, we have provided indemnifications to the buyers. Certain indemnifications cover typical representations and warranties related to our responsibilities to perform under the sales contracts. Under other indemnifications, we agree to reimburse the purchasers for taxes or ERISA-related amounts, if any, assessed after the sale date but related to pre-sale activities. We cannot quantify the maximum potential exposure covered by all of our indemnifications because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. For those with a time limit, the longest such indemnification expires on December 31, 2015. We accrue a loss when a valid claim is made by a purchaser and we believe we have potential exposure. We currently have claims under an indemnification that covers certain net insurance losses that were incurred and reinsured prior to our sale of a subsidiary. We paid $4.8 million related to such claims in 2009. At December 31, 2009, we have recorded a liability of $12.9 million and have provided a $3.0 million escrow account and $9.7 million of letters of credit to cover our obligations or anticipated payments under this indemnification.

***Subsidiary Dividends***

The principal assets of HCC are the shares of capital stock of its insurance company subsidiaries. HCC s obligations include servicing outstanding debt and interest, paying dividends to shareholders, repurchasing HCC s common stock, and paying corporate expenses. Historically, we have not relied on dividends from our insurance companies to meet HCC s obligations as we have had sufficient cash flow from our underwriting agencies to meet our corporate cash flow requirements. However, as a greater percentage of profit is now being earned in our insurance companies, we may have to increase the amount of dividends paid by our insurance companies in the future to fund HCC s cash obligations.

The payment of dividends by our insurance companies is subject to regulatory restrictions and will depend on the surplus and future earnings of these subsidiaries. HCC s direct U.S. insurance company subsidiaries can pay an aggregate of $217.8 million in dividends in 2010 without obtaining special permission from state regulatory authorities. In 2009, 2008 and 2007, our insurance company subsidiaries paid HCC dividends of $134.0 million, $111.8 million and $22.6 million, respectively.

***Other***

Our debt to total capital ratio was 9.0% at December 31, 2009 and 11.5% at December 31, 2008. Our fixed charge coverage ratio was 25.13 for 2009, 18.25 for 2008 and 29.51 for 2007.

In 2008, our Board of Directors approved the repurchase of up to $100.0 million of our common stock, as part of our philosophy of building long-term shareholder value. The share repurchase plan authorized repurchases to be made in the open market or in privately negotiated transactions from time-to-time. In 2009, we repurchased 1.7 million shares of our common stock in the open market for a total cost of $35.5 million, and a weighted-average cost of $21.36 per share. In 2008, we repurchased 3.0 million shares in the open market for a total cost of $63.3 million, or $21.02 per share. Our total repurchases of $98.8 million were at a weighted-average cost of $21.14 per share.

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

**Impact of Inflation**

Our operations, like those of other property and casualty insurers, are susceptible to the effects of inflation because premiums are established before the ultimate amounts of loss and loss adjustment expense are known.

Although we consider the potential effects of inflation when setting premium rates, our premiums, for competitive reasons, may not fully offset the effects of inflation. However, because the majority of our business is comprised of lines that have relatively short lead times between the occurrence of an insured event, reporting of the claims to us and the final settlement of the claims, or have claims that are not significantly impacted by inflation, the effects of inflation are minimized.

A portion of our revenue is related to healthcare insurance and reinsurance products that are subject to the effects of the underlying inflation of healthcare costs. Such inflation in the costs of healthcare tends to generate increases in premiums for medical stop-loss coverage, resulting in greater revenue but also higher claim payments. Inflation also may have a negative impact on insurance and reinsurance operations by causing higher claim settlements than may originally have been estimated, without an immediate increase in premiums to a level necessary to maintain profit margins. We do not specifically provide for inflation when setting underwriting terms and claim reserves, although we do consider trends. We continually review claim reserves to assess their adequacy and make necessary adjustments.

Inflation can also affect interest rates. A significant increase in interest rates could have a material adverse effect on the fair value of our investments. The fair value of our fixed income securities was $4.6 billion at December 31, 2009. If market interest rates were to change 1%, the fair value of our fixed income securities would have changed approximately $230.0 million before tax at December 31, 2009. The change in fair value was determined using duration modeling assuming no prepayments. In addition, the interest rate payable under our Revolving Loan Facility fluctuates with market interest rates. A significant increase in interest rates could have an adverse effect on our net earnings, if we have outstanding borrowings under the facility. The interest rate on our 6.30% Senior Notes is fixed and not subject to interest rate changes.

## Foreign Exchange Rate Fluctuations

We underwrite risks that are denominated in a number of foreign currencies. As a result, we have receivables and payables in foreign currencies and we establish and maintain loss reserves with respect to our insurance policies in their respective currencies. There could be a negative impact on our net earnings from the effect of exchange rate fluctuations on these assets and liabilities. Our principal area of exposure is related to fluctuations in the exchange rates between the British pound sterling, the Euro and the U.S. dollar. We constantly monitor the balance between our receivables and payables and loss reserves to mitigate the potential exposure should an imbalance be expected to exist for other than a short period of time. Imbalances are generally net liabilities, and we economically hedge such imbalances with cash and short-term investments denominated in the same foreign currency as the net imbalance. Our gain (loss) from currency conversion was $0.6 million in 2009, $1.9 million in 2008 and ($1.8) million in 2007. The 2007 loss excludes a $13.4 million charge to correct the accounting for unrealized cumulative foreign exchange gains related to certain available for sale securities discussed previously. This loss was offset by a $13.4 million realized gain for embedded net foreign currency exchange gains when the securities were sold in 2007.

## Critical Accounting Policies

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

### *Loss and Loss Adjustment Expense*

Our net loss and loss adjustment expense reserves are composed of reserves for reported losses and reserves for incurred but not reported losses (which include provisions for potential movement in reported losses, as well as for claims that have occurred but have not been reported to us), less a reduction for reinsurance recoverables related to those reserves. Reserves are recorded by product line and are undiscounted, except for reserves related to acquisitions.

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

To record reserves on our lines of business, we utilize expected loss ratios, which management selects based on the following: 1) information used to price the applicable policies, 2) historical loss information where available, 3) any public industry data for that line or similar lines of business, 4) an assessment of current market conditions and 5) a claim-by-claim review by management, where actuarially homogenous data is unavailable. Management also considers the point estimates and ranges calculated by our actuaries, together with input from our experienced underwriting and claims personnel. Because of the nature and complexities of the specialized types of business we insure, management may give greater weight to the expectations of our underwriting and claims personnel, who often perform a claim by claim review, rather than to the actuarial estimates. However, we utilize the actuarial point and range estimates to monitor the adequacy and reasonableness of our recorded reserves.

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

The table below shows our recorded net reserves at December 31, 2009 by line of business, the actuarial reserve point estimates, and the high and low ends of the actuarial reserve range as determined by our reserving actuaries.

| | Recorded Net Reserves | Actuarial Point Estimate | Low End of Actuarial Range | High End of Actuarial Range |
|---|---|---|---|---|
| **Total net reserves** | $ 2,555,840 | $ 2,464,206 | $ 2,280,181 | $ 2,727,401 |
| Individual lines of business: | | | | |
| Diversified financial products | $ 1,428,688 | $ 1,370,034 | $ 1,177,412 | $ 1,630,032 |
| Group life, accident and health | 276,599 | 270,752 | 245,773 | 297,574 |
| Aviation | 81,248 | 81,158 | 74,915 | 88,749 |
| London market account | 155,132 | 160,031 | 152,030 | 180,556 |
| Other specialty lines | 284,689 | 264,921 | 251,381 | 300,766 |
| Discontinued lines | 329,484 | 317,310 | 279,793 | 381,700 |
| **Total net reserves** | $ 2,555,840 | | | |

The excess of the total recorded net reserves over the actuarial point estimate was 3.6% of recorded net reserves at December 31, 2009, compared to 4.3% at December 31, 2008. The percentage will vary in total and by line depending on current economic events, the potential volatility of the line, the severity of claims reported and of claims incurred but not reported, management s judgment with respect to the risk of development, the nature of business acquired in acquisitions, and historical development patterns.

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

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

In actuarial practice, some of our lines of business are more effectively modeled by a statistical distribution that is skewed or non-symmetric. These distributions are usually skewed towards large losses, which causes the midpoint of the range to be above the actuarial point estimate or mean value of the range. This should be kept in mind when using the midpoint as a proxy for the mean. Our assumptions, estimates and judgments can change based on new information and changes in conditions, and, if they change, it will affect the determination of the range amounts.

The following table details, by major products within our lines of business, the characteristics and major actuarial assumptions utilized by our actuaries in the determination of actuarial point estimates and ranges. We considered all major lines of business written by the insurance industry when determining the relative characteristics of claims duration, speed of loss reporting and reserve volatility. Other companies may classify their own insurance products in different lines of business or utilize different actuarial assumptions.

| | | | Claims Characteristics | | | |
|---|---|---|---|---|---|---|
| **Line of Business** | **Products** | **Underwriting** | **Duration** | **Speed of Claim Reporting** | **Reserve Volatility** | **Major Actuarial Assumptions** |
| Diversified financial products | Directors and officers liability | Direct and subscription | Medium to long | Moderate | Medium to high | Historical and industry loss reporting patterns<br>Loss trends<br>Rate changes |
| | Errors and omissions liability | Direct | Medium | Moderate | Medium | Historical loss reporting patterns |
| | Surety | Direct | Medium | Fast | Low | Historical loss payment and reporting patterns |
| Group life, accident and health | Medical stop-loss | Direct | Short | Fast | Low | Medical cost and utilization trends<br>Historical loss payment and reporting patterns<br>Rate changes |
| | Medical excess | Direct and assumed | Short | Fast | Low to medium | Historical loss payment and reporting patterns<br>Loss trends<br>Rate changes |
| Aviation | Aviation | Direct and subscription | Medium | Fast | Medium | Historical loss payment and |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | | reporting patterns |
| London market account | Energy* | Subscription | Medium | Moderate | Medium | Historical and industry loss payment and reporting patterns Historical large loss experience |
| | Property* | Subscription | Medium | Moderate | Medium | Historical loss payment and reporting patterns Historical large loss experience |
| | Marine | Subscription | Medium | Moderate | Medium | Historical loss payment and reporting patterns Historical large loss experience |
| | Accident and health | Direct and assumed | Medium to long | Slow | High | Historical loss payment and reporting patterns |
| Other specialty | Liability | Direct and assumed | Medium | Moderate | Medium | Historical loss payment and reporting patterns |
| | Property | Direct and assumed | Short | Fast | Low | Historical loss payment and reporting patterns |
| Discontinued | Accident and health insurance | Assumed | Long | Slow | High | Historical and industry loss payment and reporting patterns |
| | Medical malpractice | Direct | Medium to long | Moderate | Medium to high | Historical loss payment and reporting patterns |

* Includes catastrophe losses

Direct insurance is coverage that is originated by our insurance companies and brokers in return for premium. Assumed reinsurance is coverage written by another insurance company, for which we assume all or a portion of the risk in exchange for all or a portion of the premium. Subscription business is direct insurance or assumed reinsurance where we only take a percentage of the total risk and premium and other insurers take their proportionate percentage of the remaining risk and premium. Assumed reinsurance represented 10% of our gross written premium in 2009 and 18% of our gross reserves at December 31, 2009. Approximately 45% of the assumed reinsurance reserves related to business in our discontinued lines, 31% related to assumed reinsurance in our London market account, aviation and diversified financial products lines of business, 15% related to assumed quota share surplus lines business in our other specialty lines, and 7% related to assumed business in our group life, accident and health line of business. The remaining assumed reinsurance reserves covered various other reinsurance programs. The table above recaps the underwriting, claims characteristics and major actuarial assumptions for our assumed reinsurance business.

The discontinued lines include run-off assumed accident and health reinsurance business, which is primarily reinsurance that provides excess coverage for large losses related to workers compensation policies. This business is subject to late reporting of claims by cedants and state guaranty associations. To mitigate our exposure to unexpected losses reported by cedants, our claims personnel review reported losses to ensure they are reasonable and consistent with our expectations. In addition, our claims personnel periodically audit the cedants claims processing functions to assess whether cedants are submitting timely and accurate claims reports to us. Disputes with insureds related to claims or coverage issues are administered in the normal course of business or settled through arbitration. Based on the late reporting of claims in the past and the higher risk of this discontinued line of business relative to our continuing lines of business, management believes there may be a greater likelihood of future adverse development in the run-off assumed accident and health reinsurance business than in our other lines of business. We reassess loss reserves for this assumed business at each quarter end and adjust them, if needed.

The majority of the assumed reinsurance in our London market account, aviation and diversified financial products lines of business is facultative reinsurance. This business involves reinsurance of a company s captive insurance program or business that must be written through another insurance company licensed to write insurance in a particular country or locality. In all cases, we underwrite the business and administer the claims, which are reported without a lag by the brokers. Disputes, if any, generally relate to claims or coverage issues with insureds and are administered in the normal course of business. We establish loss reserves for this assumed reinsurance using the same methods and assumptions we use to set reserves for comparable direct business.

Our assumed quota share surplus lines business in our other specialty lines, which we discontinued writing in 2008, is recorded monthly with a two-month time lag. Case reserves are reported directly to us by the cedant, and we establish incurred but not reported reserves based on our estimates. We periodically contact and visit the cedant to discuss loss trends and review claim files. We also receive copies of the cedant s loss triangles on individual products. Because of the frequent communication, we receive sufficient information to use many of the same methods and assumptions we would use to set reserves for comparable direct business. We have not had any disputes with the cedant.

We underwrite the assumed group life, accident and health business and administer the claims. Disputes, if any, are administered in the normal course of business. The majority of the assumed reinsurance is due to medical excess products. Although very similar to our direct medical stop-loss business, it is written as excess reinsurance of HMOs, provider groups, hospitals and other insurance companies. We establish loss reserves for this line of business using the same methods and assumptions we would use to set reserves for comparable direct business.

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The following tables show the composition of our gross, ceded and net reserves at December 31, 2009 and 2008.

| **At December 31, 2009** | **Gross** | **Ceded** | **Net** | **% Net IBNR to Net Total Reserves** |
|---|---|---|---|---|
| Reported loss reserves: | | | | |
| Diversified financial products | $ 872,623 | $ 248,398 | $ 624,225 | |
| Group life, accident and health | 185,656 | 5,249 | 180,407 | |
| Aviation | 89,819 | 33,566 | 56,253 | |
| London market account | 170,472 | 93,853 | 76,619 | |
| Other specialty lines | 194,653 | 70,669 | 123,984 | |
| Subtotal reported reserves | 1,513,223 | 451,735 | 1,061,488 | |
| Incurred but not reported reserves: | | | | |
| Diversified financial products | 1,080,932 | 276,469 | 804,463 | 56% |
| Group life, accident and health | 123,954 | 27,762 | 96,192 | 35 |
| Aviation | 37,007 | 12,012 | 24,995 | 31 |
| London market account | 88,799 | 10,286 | 78,513 | 51 |
| Other specialty lines | 252,993 | 92,288 | 160,705 | 56 |
| Subtotal incurred but not reported reserves | 1,583,685 | 418,817 | 1,164,868 | 52 |
| Discontinued lines reported reserves | 277,792 | 44,229 | 233,563 | |
| Discontinued lines incurred but not reported reserves | 117,609 | 21,688 | 95,921 | 29 |
| **Total loss and loss adjustment expense payable** | $ 3,492,309 | $ 936,469 | $ 2,555,840 | 49% |

| **At December 31, 2008** | | | | |
|---|---|---|---|---|
| Reported loss reserves: | | | | |
| Diversified financial products | $ 682,446 | $ 207,750 | $ 474,696 | |
| Group life, accident and health | 171,326 | 8,550 | 162,776 | |
| Aviation | 101,720 | 35,894 | 65,826 | |
| London market account | 272,795 | 165,468 | 107,327 | |
| Other specialty lines | 167,703 | 59,087 | 108,616 | |
| Subtotal reported reserves | 1,395,990 | 476,749 | 919,241 | |
| Incurred but not reported reserves: | | | | |
| Diversified financial products | 983,897 | 253,349 | 730,548 | 61% |
| Group life, accident and health | 133,899 | 17,204 | 116,695 | 42 |
| Aviation | 59,914 | 25,481 | 34,433 | 34 |
| London market account | 131,753 | 60,482 | 71,271 | 40 |

| | | | | |
|---|---|---|---|---|
| Other specialty lines | 239,988 | 82,848 | 157,140 | 59 |
| Subtotal incurred but not reported reserves | 1,549,451 | 439,364 | 1,110,087 | 55 |
| Discontinued lines reported reserves | 326,314 | 58,814 | 267,500 | |
| Discontinued lines incurred but not reported reserves | 143,475 | 24,032 | 119,443 | 31 |
| **Total loss and loss adjustment expense payable** | $ 3,415,230 | $ 998,959 | $ 2,416,271 | 51% |

We determine our incurred but not reported reserves by first projecting the ultimate expected losses by product within each line of business. We then subtract paid losses and reported loss reserves from the ultimate loss reserves. The remainder is our incurred but not reported reserves. The level of incurred but not reported reserves in relation to total reserves depends upon the characteristics of the specific line of business, particularly with respect to the speed with which losses are reported and outstanding claims reserves are adjusted. Lines for which losses are reported fast will have a lower percentage of incurred but not reported

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loss reserves than slower reporting lines, and lines for which reserve volatility is low will have a lower percentage of incurred but not reported loss reserves than high volatility lines.

The reserves for reported losses related to our direct business and certain reinsurance assumed are initially set by our claims personnel or independent claims adjusters we retain. The reserves are subject to our review, with a goal of setting them at the ultimate expected loss amount as soon as possible when the information becomes available. Reserves for reported losses related to other reinsurance assumed are recorded based on information supplied to us by the ceding company. Our claims personnel monitor these reinsurance assumed reserves on a current basis and audit ceding companies claims to ascertain that claims are being recorded currently and that net reserves are being set at levels that properly reflect the liability related to the claims.

The percentage of net incurred but not reported reserves to net total reserves was 49% at December 31, 2009 and 51% at December 31, 2008. The reasons, by line of business, for changes in net reserves and the percentage of incurred but not reported reserves to total net reserves, other than changes related to normal maturing of claims, follow:

*Diversified financial products* Total net reserves increased $223.4 million from 2008 to 2009 as this line of business continues to grow. The incurred but not reported portion of the total reserves for this line of business is higher than in most of our other lines, since these losses report slower and have a longer duration. This line includes our directors and officers liability, errors and omissions liability, and fiduciary liability coverages, which have experienced increased notices of claims, primarily from financial institutions, due to market and credit-related issues. The percentage of incurred but not reported reserves has decreased as claims mature.

*Group life, accident and health* Total net reserves are flat year-over-year. The percentage of incurred but not reported reserves decreased in 2009 due to growth in our relatively new short-term medical products, for which claims are reported and settled faster.

*London market account* Total net reserves decreased and the percentage of incurred but not reported reserves increased due to payment of claims on prior year hurricanes previously reported in case reserves.

*Other specialty lines* Total net reserves increased due to our increased participation in our Lloyd s of London syndicates, as well as growth in new products.

*Discontinued lines* Total net reserves for our discontinued lines decreased $57.5 million in 2009, primarily due to a $43.9 million commutation of certain loss reserves for run-off assumed accident and health reinsurance business.

Our net reserves historically have shown favorable development except for the effects of commutations, which we have completed in the past and may negotiate in the future. Commutations can produce adverse prior year development because, under generally accepted accounting principles, any excess of undiscounted reserves assumed over assets received must be recorded as a loss at the time the commutation is completed. Economically, the loss generally represents the discount for the time value of money that will be earned over the payout of the reserves; thus, the loss may be recouped as investment income is earned on the assets received. Based on our reserving techniques and our past results, we believe that our net reserves are adequate.

During 2008 and 2009, we conducted additional reviews of our potential loss exposures stemming from the U.S. and international economic environment, including subprime lending and trade credit issues. We write directors and officers liability, errors and omissions liability and fiduciary liability coverages for public and private companies and not-for-profit organizations. Certain of this business is written for financial institutions that have potential exposure to shareholder lawsuits as a result of the economic environment during the past few years. At December 31, 2009, we had 17 Side A only and 75 non-Side A only directors and officers liability, errors and omissions liability and fiduciary liability claims related to subprime and credit market issues. This compares to 15 Side A only and 57 non-Side A only claims at December 31, 2008. In reviewing our exposure, we consider the types of risks we wrote, the industry of our insured, attachment points with respect to excess business, types of coverage, policy limits, actual claims reported, and current legal interpretations and decisions. We also write trade credit business for policyholders who have credit and political risk exposure. We continue to closely monitor our exposure to subprime and trade credit issues. Based on our present knowledge, we believe our ultimate losses from these coverages will be contained within our current overall loss reserves for this business.

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

***Reinsurance Recoverables***

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

The reserve was $2.9 million at December 31, 2009, compared to $8.4 million at December 31, 2008. During 2009, we wrote off $0.9 million of uncollectible recoverables against the reserve. We also recognized a $4.6 million benefit from reversing a portion of the reserve based on actual or expected cash collections from reinsurers, for which reserves had previously been established. We assessed the collectibility of our year-end recoverables and believe amounts are collectible and any potential losses are adequately reserved based on currently available information.

***Deferred Taxes***

We recognize deferred tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. We regularly review our deferred tax assets for recoverability and establish a valuation allowance based on our history of earnings, expectations for future earnings, taxable income in carryback years and the expected timing of the reversals of existing temporary differences. Although realization is not assured, we believe that, as of December 31, 2009, it is more likely than not that we will be able to realize the benefit of recorded deferred tax assets, with the exception of certain tax loss carryforwards for which valuation allowances have been provided. If there is a material change in the tax laws such that the actual effective tax rate changes or the time periods within which the underlying temporary differences become taxable or deductible change, we will need to reevaluate our assumptions, which could result in a change in the valuation allowance required.

***Valuation of Goodwill***

When we complete a business combination, goodwill is either allocated to the reporting unit in which the acquired business is included or, if there are synergies with our other businesses, allocated to the different reporting units based on their respective share of the estimated future cash flows. In our insurance company segment, our reporting units are either individual subsidiaries or groups of subsidiaries that share common licensing and other characteristics. In our agency and other operations segments, our reporting units are individual subsidiaries. We sold one subsidiary in October 2009, which had been a reporting unit in our agency segment when we conducted our 2009 goodwill impairment test.

An indicator of impairment of goodwill exists when the fair value of a reporting unit is less than its carrying amount. We assess our goodwill for impairment annually, or sooner if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. We conducted our 2009 goodwill impairment test as of June 30, 2009, which is consistent with the timeframe for our annual assessment in prior years. Based on our latest impairment test, the fair value of each of our reporting units exceeded its carrying amount. No events have occurred that indicate there is an impairment in our goodwill as of December 31, 2009.

For our 2009 impairment test, we incorporated new accounting guidance, which required us to consider three valuation approaches (market, income and cost) to determine the fair value of each reporting unit. We utilized the market and income approaches and based our assumptions and inputs on market participant data, rather than our own data. For the income approach, we estimated the present value of expected cash flows to determine the fair value of each reporting unit. We utilized estimated future cash flows, probabilities as to occurrence of these cash flows, a risk-free rate of interest, and a risk premium for uncertainty in the cash flows. We weighted the results of the market and income approaches to determine the calculated fair value of each reporting unit. Prior to 2009, we used the expected cash flow approach with assumptions and inputs based on our own internal data to determine the fair value of each reporting unit. In all years, we utilized our budgets and projection of future operations based on historical and expected industry trends to estimate our future cash flows and their probability of occurring as projected.

***Other-than-temporary Impairments in Investments***

A security has an impairment loss when its fair value is less than its cost or amortized cost at the balance sheet date. The gross unrealized losses in our available for sale fixed income securities was $18.9 million at December 31, 2009 (0.4% of aggregate fair value of total available for sale fixed income securities) compared to $91.3 million (2.2% of aggregate fair value) at December 31, 2008. We evaluate the securities in our fixed income securities portfolio for possible other-than-temporary impairment losses at each quarter end.

Prior to April 1, 2009, we assessed our ability and intent to hold an impaired security for a period of time sufficient to allow full recovery or until maturity. If we could not assert this condition, we recorded the difference between fair value and amortized cost as an other-than-temporary impairment loss through earnings in that period. Based on this criteria, we recorded other-than-temporary impairment losses of $3.1 million in the first quarter of 2009, $11.1 million in 2008 and none in 2007. Our quarterly reviews covered all impaired securities where the loss exceeded $0.5 million and the loss either exceeded 10% of cost or the security had been in a loss position for longer than 12 consecutive months.

As of April 1, 2009, we adopted a new accounting standard, which specifies new criteria for identification and recognition of other-than-temporary impairment losses. This standard requires us to determine, for each impaired fixed income security, that: 1) we do not intend to sell the security and 2) it is more likely than not that we will not be required to sell the security before recovery of its amortized cost basis. If we cannot assert these conditions, we record the impairment as an other-than-temporary loss through earnings in the current period. For all other impaired securities, the impairment is considered an other-than-temporary loss if the net present value of the cash flows expected to be collected from the security is less than its amortized cost basis. Such a shortfall in cash flows is referred to as a credit loss. For any such security, we separate the impairment loss into: 1) the credit loss and 2) the amount related to all other factors, such as interest rate changes, market conditions, etc. (the non-credit loss). The credit loss is charged to current period earnings and the non-credit loss is charged to other comprehensive income, within shareholders equity, on an after-tax basis.

To adopt the new accounting standard, we reviewed all securities with a previous other-than-temporary impairment loss that we still held at April 1, 2009. For each, we determined the credit and non-credit component as of the adoption date. We calculated the net present value of each security by discounting our best estimate of projected future cash flows at the effective interest rate implicit in the security prior to impairment. For our mortgage-backed securities, the estimated cash flows included prepayment assumptions and other assumptions regarding the underlying collateral including default rates, recoveries and changes in value. We recorded a cumulative adjustment of

$4.3 million after-tax to reclassify the non-credit portion of the loss from retained earnings to accumulated other comprehensive income as of the adoption date.

Since April 1, 2009, we have reviewed our impaired securities at each quarter end and assessed whether we have any other-than-temporary impairment losses, based on all relevant facts and circumstances for each impaired security. To assist us in our evaluation, our outside investment advisor also performs detailed credit evaluations of all of our fixed income securities on an ongoing basis. Our quarterly reviews have covered all impaired securities where the loss exceeded $0.5 million and the loss either exceeded 10% of cost or the security had been in a loss position for longer than twelve consecutive months. Our reviews considered various factors including:

- amount by which the security s fair value is less than its cost,
- length of time the security has been impaired,
- whether we intend to sell the security,
- if it is more likely than not that we will have to sell the security before recovery of its amortized cost basis,
- whether the impairment is due to an issuer-specific event,
- the security s credit rating and any recent downgrades, and
- stress testing of expected cash flows for mortgage-backed and asset-backed securities under various scenarios.

The new accounting standard also changed the earnings recognition criteria for other-than-temporary impairment losses. We now recognize an other-than-temporary impairment loss in earnings in the period we determine: 1) we intend to sell the security, 2) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis, or 3) the security has a credit loss. Any non-credit portion of the other-than-temporary impairment loss is recognized in shareholders equity. In 2009, we recognized $6.4 million of pretax other-than-temporary impairment losses, of which $5.4 million were recorded in earnings and $1.0 million were recorded in shareholders equity. At December 31, 2009, we had $5.0 million of after-tax other-than-temporary impairments, primarily related to mortgage-backed and asset-backed securities, included in shareholders equity.

## Accounting Guidance Adopted in 2009

See Note 1 of the Consolidated Financial Statements for additional information about new accounting guidance that we adopted in 2009 in the following areas: 1) codification, 2) convertible debt, 3) fair value measurements, 4) earnings per share, 5) business combinations, 6) consolidation and 7) derivatives.

## Recent Accounting Guidance

A new accounting standard, originally issued as SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, was issued in June 2009. The guidance, which will be incorporated into Accounting Standards Codification Topic 810, *Consolidation*, changes various aspects of accounting for and disclosures of interests in variable interest entities. We will adopt the guidance effective January 1, 2010. Our adoption of this guidance will not have a material impact on our consolidated financial statements.

## Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

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

## Interest Rate Risk

During 2008, there was significant volatility and disruption in the financial and credit markets. A number of large financial institutions failed, were supported by the United States government or were merged into other companies. The market disruption resulted in a lack of liquidity in the credit market for many other companies and a widening of credit spreads. The markets improved in 2009 and the net pretax unrealized gain on our fixed income securities increased $141.7 million compared to a $10.4 million decrease in 2008.

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

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

The fair value of our fixed income securities was $4.6 billion at December 31, 2009 and $4.3 billion at December 31, 2008. If market interest rates were to change 1%, the fair value of our fixed income securities would have changed approximately $230.0 million before tax at December 31, 2009. This compares to a change in fair value of approximately $200.0 million before tax at December 31, 2008 for the same 1% change in market interest rates. The change in fair value was determined using duration modeling assuming no prepayments.

Our $575.0 million Revolving Loan Facility is subject to variable interest rates. At December 31, 2009, there were no outstanding borrowings on the facility. Our 6.30% Senior Notes are not subject to interest rate changes.

**Foreign Exchange Risk**

The table below shows the net amounts of significant foreign currency balances for subsidiaries with a U.S. dollar functional currency at December 31, 2009 and 2008 converted to U.S. dollars. It also shows the expected dollar change in fair value (in thousands) that would occur if exchange rates changed 10% from exchange rates in effect at those times.

| | December 31, | | | |
|---|---|---|---|---|
| | 2009 | | 2008 | |
| | U.S. Dollar Equivalent | Hypothetical 10% Change in Fair Value | U.S. Dollar Equivalent | Hypothetical 10% Change in Fair Value |
| British pound sterling | $ 8,385 | $ 839 | $ 13,074 | $ 1,307 |
| Euro | 2,626 | 263 | 649 | 65 |

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

**Item 8.** ***Financial Statements and Supplementary Data***

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

**Item 9.** ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

## Item 9A. *Controls and Procedures*

### Evaluation of Disclosure Controls and Procedures

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

Our management, with the participation of our CEO and CFO, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2009. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of December 31, 2009.

### Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America (generally accepted accounting principles). Internal control over financial reporting includes those policies and procedures that: 1) pertain to the maintenance of our records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of our assets, 2) provide reasonable assurance that we have recorded transactions as necessary to permit us to prepare consolidated financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of our management and Board of Directors and 3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our consolidated financial statements.

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

Management, including our CEO and CFO, conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2009 based on criteria established in the *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on the results of this assessment, management concluded that our internal control over financial reporting was effective as of December 31, 2009 and that the consolidated financial statements included in this Report present fairly, in all material respects, our financial position, results of operations and cash flows for the years presented in accordance with generally accepted accounting principles.

The effectiveness of our internal control over financial reporting as of December 31, 2009 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report, which is included in Item 8 of this Report.

## Changes in Internal Control Over Financial Reporting

During the fourth quarter of 2009, there were no changes in our internal control of financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## Item 9B. *Other Information*

We have disclosed all information required to be disclosed in a current report on Form 8-K during the fourth quarter of 2009 in previously filed reports on Form 8-K.

# PART III

## Item 10. *Directors, Executive Officers and Corporate Governance*

### Code of Business Conduct and Ethics

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

For information regarding our Directors, Executive Officers and Corporate Governance, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009 and which is incorporated herein by reference.

## Item 11. *Executive Compensation*

For information regarding Executive Compensation, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009 and which is incorporated herein by reference.

## Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

For information regarding Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009 and which is incorporated herein by reference.

## Item 13. *Certain Relationships and Related Transactions, and Director Independence*

For information regarding Certain Relationships and Related Transactions, and Director Independence, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009 and which is incorporated herein by reference.

## Item 14. *Principal Accountant Fees and Services*

For information regarding Principal Accountant Fees and Services, reference is made to our definitive proxy statement for our Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2009 and which is incorporated herein by reference.

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## PART IV

### Item 15. *Exhibits and Financial Statement Schedules*

(a) *Financial Statement Schedules*

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

(b) *Exhibits*

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

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HCC Insurance Holdings, Inc.
(Registrant)

Dated: March 1, 2010 By: /s/ John N. Molbeck, Jr.

(John N. Molbeck, Jr.)
President and Chief Executive Officer

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

| Name | Title | Date |
|---|---|---|
| /s/ John N. Molbeck, Jr.<br>(John N. Molbeck, Jr.) | Director, President and Chief Executive Officer (Principal Executive Officer) | March 1, 2010 |
| /s/ Judy C. Bozeman*<br>(Judy C. Bozeman) | Director | March 1, 2010 |
| /s/ Frank J. Bramanti*<br>(Frank J. Bramanti) | Director | March 1, 2010 |
| /s/ Walter M. Duer*<br>(Walter M. Duer) | Director | March 1, 2010 |
| /s/ James C. Flagg, Ph.D.*<br>(James C. Flagg, Ph.D.) | Director | March 1, 2010 |
| /s/ Thomas M. Hamilton*<br>(Thomas M. Hamilton) | Director | March 1, 2010 |
| /s/ James E. Oesterreicher* | Director | March 1, 2010 |

| | | |
|---|---|---|
| (James E. Oesterreicher) | | |
| /s/ Robert A. Rosholt* | Director | March 1, 2010 |
| (Robert A. Rosholt) | | |
| /s/ Christopher J. B. Williams* | Director and Chairman of the Board | March 1, 2010 |
| (Christopher J. B. Williams) | | |
| /s/ Scott W. Wise* | Director | March 1, 2010 |
| (Scott W. Wise) | | |
| /s/ William. T. Whamond | Executive Vice President and Chief Financial Officer | March 1, 2010 |
| (William T. Whamond) | | |
| /s/ Pamela J. Penny | Executive Vice President and Chief Accounting Officer | March 1, 2010 |
| (Pamela J. Penny) | | |

*By: /s/ Pamela J. Penny

Pamela J. Penny
Attorney-in-fact

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## INDEX TO EXHIBITS

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

| Exhibit Number | |
|---|---|
| (A)3.1 | Restated Certificate of Incorporation and Amendment of Certificate of Incorporation of HCC Insurance Holdings, Inc., filed with the Delaware Secretary of State on July 23, 1996 and May 21, 1998, respectively. |
| (B)3.2 | Amended and Restated Bylaws of HCC Insurance Holdings, Inc. |
| (C)4.1 | Specimen of Common Stock Certificate, $1.00 par value, of HCC Insurance Holdings, Inc. |
| (D)4.2 | Indenture dated August 23, 2001 between HCC Insurance Holdings, Inc. and First Union National Bank related to Debt Securities (Senior Debt). |
| (E)4.3 | Second Supplemental Indenture dated March 28, 2003 between HCC Insurance Holdings, Inc. and Wachovia Bank, National Association (as successor to First Union National Bank) related to 1.30% Convertible Notes Due 2023. |
| (F)4.4 | First Amendment to Second Supplemental Indenture dated December 22, 2004 between HCC Insurance Holdings, Inc. and Wachovia Bank, National Association related to 1.30% Convertible Notes Due 2023. |
| (G)4.5 | Form of Fourth Supplemental Indenture, dated as of November 16, 2009 between HCC Insurance Holdings, Inc. and U.S. Bank National Association related to the 6.300% Senior Notes due 2019. |
| (H)10.1 | Loan Agreement ($300,000,000 Revolving Loan Facility) dated as of April 4, 2007 among HCC Insurance Holdings, Inc.; Wells Fargo Bank, National Association; Citibank, N.A.; Wachovia Bank, National Association; Royal Bank of Scotland; Amegy Bank, National Association and The Bank of New York. |
| (I)10.2 | First Amendment to Loan Agreement dated as of October 23, 2007 by and among HCC Insurance Holdings, Inc. and Wells Fargo Bank, National Association; Citibank, N.A.; Wachovia Bank, National Association; Royal Bank of Scotland; Amegy Bank, National Association; The Bank of New York; Key Bank National Association; Bank of America, N.A.; and Deutsche Bank AG New York Branch. |
| (J)10.3 | $152,000,000 Standby Letter of Credit Facility dated November 24, 2009 by and between HCC Insurance Holdings, Inc. and the Royal Bank of Scotland plc and Barclays Bank plc. |
| (K)10.4 | HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan. |
| (L)10.5 | Form of Restricted Stock Award Agreement under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan. |
| (L)10.6 | Form of Nonqualified Stock Option Agreement under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan. |
| (L)10.7 | Form of Restricted Stock Unit Award Agreement under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan. |
| (M)10.8 | HCC Insurance Holdings, Inc. 2007 Incentive Compensation Plan. |
| (N)10.9 | Amended and Restated Employment Agreement effective January 1, 2007, between HCC Insurance Holdings, Inc. and Frank J. Bramanti. |
| (O)10.10 | Separation Agreement between Frank J. Bramanti and HCC Insurance Holdings, Inc., effective May 5, 2009. |
| (P)10.11 | Employment Agreement effective March 1, 2007, between HCC Insurance Holdings, Inc. and John N. Molbeck, Jr. |

| | |
|---|---|
| (Q)10.12 | Employment Agreement between John N. Molbeck, Jr. and HCC Insurance Holdings, Inc., effective May 5, 2009. |
| (P)10.13 | Employment Agreement effective March 1, 2007, between HCC Insurance Holdings, Inc. and Craig J. Kelbel. |
| (Q)10.14 | First Amendment to Employment Agreement of Craig J. Kelbel effective as of September 1, 2009. |

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| Exhibit Number | |
|---|---|
| (P)10.15 | Employment Agreement effective June 1, 2007, between HCC Insurance Holdings, Inc. and Michael J. Schell. |
| (N)10.16 | First Amendment to Employment Agreement effective December 31, 2008, between HCC Insurance Holdings, Inc. and Michael J. Schell. |
| (P)10.17 | Employment Agreement effective March 1, 2007, between HCC Insurance Holdings, Inc. and Edward H. Ellis, Jr. |
| (R)10.18 | Consulting Agreement effective as of January 1, 2010 by and between HCCS Corporation dba HCC Service Company and Edward H. Ellis, Jr. |
| (S)10.19 | Amended and Restated Employment Agreement effective September 1, 2008, between HCC Insurance Holdings, Inc. and Cory L. Moulton. |
| (R)10.20 | Amended and Restated Employment Agreement dated effective as of November 30, 2009, by and between HCC Insurance Holdings, Inc. and Cory L. Moulton. |
| (T)10.21 | Employment Agreement between William T. Whamond and HCC Insurance Holdings, Inc., effective May 1, 2009. |
| (U)10.22 | Service Agreement effective as of January 1, 2006, between HCC Service Company Limited (UK) Branch and Barry J. Cook. |
| (V)10.23 | HCC Insurance Holdings, Inc. Nonqualified Deferred Compensation Plan for Frank J. Bramanti. |
| (V)10.24 | HCC Insurance Holdings, Inc. Nonqualified Deferred Compensation Plan for John N. Molbeck, Jr. |
| (W)10.25 | HCC Insurance Holdings, Inc. Nonqualified Deferred Compensation Plan for John N. Molbeck, Jr., effective May 5, 2009. |
| (W)10.26 | Form of Amendment to Non-Employee Director Stock Option Agreement dated effective as of May 21, 2009. |
| (W)10.27 | Amendment to Stock Option Agreements dated effective as of May 20, 2009, by and between HCC Insurance Holdings, Inc. and Frank J. Bramanti. |
| 10.28 | Form of Restricted Stock Award Agreement under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan (service shares). |
| 10.29 | Form of Restricted Stock Award Agreement under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan (performance shares). |
| 10.30 | Form of Restricted Stock Award Agreement (US) under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan. |
| 10.31 | Form of Restricted Stock Unit Award Agreement under the HCC Insurance Holdings, Inc. 2008 Flexible Incentive Plan. |
| 12 | Statement Regarding Computation of Ratios. |
| 21 | Subsidiaries of HCC Insurance Holdings, Inc. |
| 23 | Consent of Independent Registered Public Accounting Firm PricewaterhouseCoopers LLP dated March 1, 2010. |
| 24 | Powers of Attorney. |
| 31.1 | Certification by Chief Executive Officer. |
| 31.2 | Certification by Chief Financial Officer. |
| 32.1 | Certification with respect to Annual Report of HCC Insurance Holdings, Inc. |

(A) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Registration Statement on Form S-8 (Registration No. 333-61687) filed August 17, 1998.

(B) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated March 30, 2008.

(C) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Registration Statement on Form S-1 (Registration No. 33-48737) filed October 27, 1992.

(D) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated August 19, 2001.

(E) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated March 25, 2003.

(F) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated December 22, 2004.

(G) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated November 10, 2009.

(H) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated April 4, 2007.

(I) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated October 24, 2007.

(J) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K November 24, 2009.

(K) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Registration Statement on Form S-8 (Registration No. 33-152897) filed August 8, 2008.

(L) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-Q for the Quarter Ended September 30, 2008.

(M) Incorporated by reference to the Appendix of HCC Insurance Holdings, Inc. s Definitive Proxy Statement for the May 10, 2007 Annual Meeting of Shareholders filed April 13, 2007.

(N) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated December 19, 2008.

(O) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated May 5, 2009.

(P) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated August 10, 2007.

(Q) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated August 25, 2009.

(R) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated November 18, 2009.

(S) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-K for the Year Ended December 31, 2008.

(T) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated April 27, 2009.

(U) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 10-Q for the Quarter Ended March 31, 2007.

(V) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated August 30, 2007.

(W) Incorporated by reference to the Exhibits to HCC Insurance Holdings, Inc. s Form 8-K dated May 20, 2009.

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## INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND SCHEDULES



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

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
HCC Insurance Holdings, Inc.

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of HCC Insurance Holdings, Inc. and its subsidiaries at December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedules, and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for other-than-temporary impairments and certain convertible debt instruments in 2009.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

/s/ PricewaterhouseCoopers LLP

Houston, TX
February 26, 2010

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## HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS
**(in thousands, except per share data)**

| | December 31, 2009 | December 31, 2008 |
|---|---|---|
| **ASSETS** | | |
| Investments: | | |
| Fixed income securities available for sale, at fair value (amortized cost: 2009 $4,381,762; 2008 $4,118,539) | $ 4,538,073 | $ 4,133,165 |
| Fixed income securities held to maturity, at amortized cost (fair value: 2009 $104,008; 2008 $125,561) | 102,792 | 123,553 |
| Short-term investments, at cost, which approximates fair value | 810,673 | 497,477 |
| Other investments | 4,691 | 50,088 |
| Total investments | 5,456,229 | 4,804,283 |
| Cash | 129,460 | 27,347 |
| Restricted cash and cash investments | 146,133 | 174,905 |
| Premium, claims and other receivables | 600,332 | 770,823 |
| Reinsurance recoverables | 1,016,411 | 1,054,950 |
| Ceded unearned premium | 270,436 | 234,375 |
| Ceded life and annuity benefits | 61,313 | 64,235 |
| Deferred policy acquisition costs | 208,463 | 188,652 |
| Goodwill | 822,006 | 858,849 |
| Other assets | 123,608 | 153,581 |
| **Total assets** | $ 8,834,391 | $ 8,332,000 |
| **LIABILITIES** | | |
| Loss and loss adjustment expense payable | $ 3,492,309 | $ 3,415,230 |
| Life and annuity policy benefits | 61,313 | 64,235 |
| Reinsurance balances payable | 182,661 | 122,189 |
| Unearned premium | 1,044,747 | 977,426 |
| Deferred ceding commissions | 71,595 | 63,123 |
| Premium and claims payable | 154,596 | 405,287 |
| Notes payable | 298,483 | 343,649 |
| Accounts payable and accrued liabilities | 497,504 | 300,838 |
| **Total liabilities** | 5,803,208 | 5,691,977 |
| **SHAREHOLDERS EQUITY** | | |
| Common stock, $1.00 par value; 250,000 shares authorized (shares issued: 2009 118,724 and 2008 116,457; outstanding: 2009 114,051 and 2008 113,444) | 118,724 | 116,457 |

| | | |
|---|---|---|
| Additional paid-in capital | 914,339 | 881,534 |
| Retained earnings | 1,977,254 | 1,677,831 |
| Accumulated other comprehensive income | 119,665 | 27,536 |
| Treasury stock, at cost (shares: 2009 4,673 and 2008 3,013) | (98,799) | (63,335) |
| **Total shareholders equity** | 3,031,183 | 2,640,023 |
| **Total liabilities and shareholders equity** | $ 8,834,391 | $ 8,332,000 |

See Notes to Consolidated Financial Statements.

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**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF EARNINGS**
**(in thousands, except per share data)**

| | Years Ended December 31, 2009 | 2008 | 2007 |
|---|---|---|---|
| **REVENUE** | | | |
| Net earned premium | $ 2,037,235 | $ 2,007,774 | $ 1,985,086 |
| Fee and commission income | 103,690 | 125,201 | 140,092 |
| Net investment income | 191,965 | 164,751 | 206,462 |
| Other operating income | 34,391 | 9,638 | 43,545 |
| Net realized investment gain (loss) | 12,076 | (16,808) | 13,188 |
| Other-than-temporary impairment loss: | | | |
| Total loss | (6,443) | (11,133) | |
| Portion recognized in other comprehensive income | 1,014 | | |
| Net loss recognized in earnings | (5,429) | (11,133) | |
| **Total revenue** | 2,373,928 | 2,279,423 | 2,388,373 |
| **EXPENSE** | | | |
| Loss and loss adjustment expense, net | 1,215,759 | 1,211,873 | 1,183,947 |
| Policy acquisition costs, net | 363,966 | 381,441 | 366,610 |
| Other operating expense | 259,488 | 233,509 | 241,642 |
| Interest expense | 16,164 | 20,362 | 16,270 |
| **Total expense** | 1,855,377 | 1,847,185 | 1,808,469 |
| Earnings before income tax expense | 518,551 | 432,238 | 579,904 |
| Income tax expense | 164,683 | 130,118 | 188,351 |
| **Net earnings** | $ 353,868 | $ 302,120 | $ 391,553 |
| **Earnings per common share:** | | | |
| Basic | $ 3.14 | $ 2.63 | $ 3.47 |
| Diluted | $ 3.11 | $ 2.61 | $ 3.35 |

See Notes to Consolidated Financial Statements.

## HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
**(in thousands)**

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2009** | **2008** | **2007** |
| Net earnings | $ 353,868 | $ 302,120 | $ 391,553 |
| Other comprehensive income (loss): | | | |
| Investment gains (losses): | | | |
| Investment gains (losses) during year | 147,166 | (37,290) | 41,880 |
| Income tax charge (benefit) | 53,909 | (14,985) | 14,416 |
| Investment gains (losses), net of tax | 93,257 | (22,305) | 27,464 |
| Less reclassification adjustments for: | | | |
| Gains (losses) included in net earnings | 5,483 | (19,828) | 37,461 |
| Income tax charge (benefit) | 1,920 | (6,940) | 13,111 |
| Gains (losses) included in net earnings, net of tax | 3,563 | (12,888) | 24,350 |
| Net investment gains (losses) | 89,694 | (9,417) | 3,114 |
| Cash flow hedge gain (loss) | 8,031 | (5,543) | (2,488) |
| Income tax charge (benefit) | 2,811 | (1,940) | (871) |
| Cash flow hedge gain (loss), net of tax | 5,220 | (3,603) | (1,617) |
| Foreign currency translation adjustment | 5,190 | (10,425) | 13,276 |
| Income tax charge (benefit) | 3,674 | (3,099) | 863 |
| Foreign currency translation adjustment, net of tax | 1,516 | (7,326) | 12,413 |
| Other comprehensive income (loss) | 96,430 | (20,346) | 13,910 |
| **Comprehensive income** | $ 450,298 | $ 281,774 | $ 405,463 |

See Notes to Consolidated Financial Statements.

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## HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY
**Years ended December 31, 2009, 2008 and 2007**
**(in thousands, except per share data)**

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total Shareholders Equity |
|---|---|---|---|---|---|---|
| **Balance at December 31, 2006** | $ 111,731 | $ 817,880 | $ 1,086,426 | $ 33,972 | $ | $ 2,050,009 |
| Cumulative effect of accounting change (uncertain tax positions) | | | (678) | | | (678) |
| Net earnings | | | 391,553 | | | 391,553 |
| Other comprehensive income | | | | 13,910 | | 13,910 |
| Issuance of 1,101 shares for exercise of options, including tax effect | 1,101 | 23,432 | | | | 24,533 |
| Issuance of 2,215 shares for debt conversion | 2,215 | (2,215) | | | | |
| Stock-based compensation | 22 | 11,989 | | | | 12,011 |
| Cash dividends declared, $0.42 per share | | | (47,643) | | | (47,643) |
| **Balance at December 31, 2007** | 115,069 | 851,086 | 1,429,658 | 47,882 | | 2,443,695 |
| Net earnings | | | 302,120 | | | 302,120 |
| Other comprehensive loss | | | | (20,346) | | (20,346) |
| Issuance of 1,011 shares for exercise of options, including tax effect | 1,011 | 17,187 | | | | 18,198 |
| Purchase of 3,013 common shares | | | | | (63,335) | (63,335) |
| Stock-based compensation | 377 | 13,261 | | | | 13,638 |
| Cash dividends declared, $0.47 per share | | | (53,947) | | | (53,947) |
| **Balance at December 31, 2008** | 116,457 | 881,534 | 1,677,831 | 27,536 | (63,335) | 2,640,023 |
| Cumulative effect of accounting change (other-than-temporary | | | 4,301 | (4,301) | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| impairments in investments) | | | | | | |
| Net earnings | | | 353,868 | | | 353,868 |
| Other comprehensive income | | | | 96,430 | | 96,430 |
| Issuance of 993 shares for exercise of options, including tax effect | 993 | 18,205 | | | | 19,198 |
| Purchase of 1,660 common shares | | | | | (35,464) | (35,464) |
| Issuance of 1,040 shares for debt conversion | 1,040 | (1,040) | | | | |
| Stock-based compensation | 234 | 15,640 | | | | 15,874 |
| Cash dividends declared, $0.52 per share | | | (58,746) | | | (58,746) |
| **Balance at December 31, 2009** | $ 118,724 | $ 914,339 | $ 1,977,254 | $ 119,665 | $ (98,799) | $ 3,031,183 |

See Notes to Consolidated Financial Statements.

**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(in thousands)**

| | Years Ended December 31, 2009 | 2008 | 2007 |
|---|---|---|---|
| **Operating activities:** | | | |
| Net earnings | $ 353,868 | $ 302,120 | $ 391,553 |
| Adjustments to reconcile net earnings to cash provided by operating activities: | | | |
| Change in premium, claims and other receivables | 23,432 | 46,985 | 97,304 |
| Change in reinsurance recoverables | 42,521 | (98,354) | 213,353 |
| Change in ceded unearned premium | (34,107) | 10,309 | (18,436) |
| Change in loss and loss adjustment expense payable | 22,439 | 188,264 | 129,203 |
| Change in reinsurance balances payable | 60,057 | (8,014) | 7,002 |
| Change in unearned premium | 48,366 | 33,526 | 21,498 |
| Change in premium and claims payable, net of restricted cash | (98,675) | (80,219) | (164,977) |
| Change in accounts payable and accrued liabilities | 96,040 | (53,079) | 38,351 |
| Change in trading securities | | 49,091 | 9,362 |
| Stock-based compensation expense | 15,628 | 13,638 | 12,011 |
| Depreciation and amortization expense | 16,221 | 14,308 | 15,982 |
| (Gain) loss on investments | (3,518) | 49,549 | (58,736) |
| Other, net | 40,525 | 37,844 | 32,966 |
| **Cash provided by operating activities** | 582,797 | 505,968 | 726,436 |
| **Investing activities:** | | | |
| Sales of available for sale fixed income securities | 551,760 | 583,211 | 438,057 |
| Maturity or call of available for sale fixed income securities | 347,794 | 323,998 | 302,876 |
| Maturity or call of held to maturity fixed income securities | 86,364 | | |
| Cost of available for sale fixed income securities acquired | (1,159,796) | (1,527,664) | (1,377,205) |
| Cost of held to maturity fixed income securities acquired | (59,754) | (44,592) | |
| Cost of other investments acquired | | (36,751) | (545) |
| Change in short-term investments | (297,016) | 294,248 | (72,279) |
| Proceeds from sales of strategic and other investments | 114,940 | 77,097 | 46,612 |
| Payments for purchase of businesses, net of cash received | (38,018) | (103,153) | (65,112) |
| Proceeds from sales of assets of business and subsidiary | 50,557 | | |
| Other, net | (16,581) | (7,996) | (9,741) |
| **Cash used by investing activities** | (419,750) | (441,602) | (737,337) |
| **Financing activities:** | | | |
| Issuance of notes payable | 296,096 | | |
| Advances on line of credit | 130,000 | 181,000 | 232,000 |

| | | | |
|---|---|---|---|
| Payments on line of credit and convertible notes | (410,242) | (161,000) | (205,763) |
| Sale of common stock | 19,198 | 18,198 | 24,533 |
| Purchase of common stock | (35,464) | (63,335) | |
| Dividends paid | (57,437) | (52,453) | (46,158) |
| Other, net | (3,085) | 1,436 | (2,866) |
| **Cash provided (used) by financing activities** | (60,934) | (76,154) | 1,746 |
| Net increase (decrease) in cash | 102,113 | (11,788) | (9,155) |
| Cash at beginning of year | 27,347 | 39,135 | 48,290 |
| **Cash at end of year** | $ 129,460 | $ 27,347 | $ 39,135 |

See Notes to Consolidated Financial Statements

**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**(tables in thousands, except per share data)**

## (1) General Information and Significant Accounting and Reporting Policies

HCC Insurance Holdings, Inc. and its subsidiaries (collectively, we, us or our) include domestic and foreign property and casualty and life insurance companies and underwriting agencies. We provide specialized property and casualty, surety, and group life, accident and health insurance coverages and related agency services to commercial customers and individuals. We market our products both directly to customers and through a network of independent brokers, producers, agents and third party administrators. Our lines of business include diversified financial products (which includes directors and officers liability, errors and omissions liability (known as professional indemnity outside the U.S.), employment practices liability, surety, credit, and fidelity coverages); group life, accident and health (which includes medical stop-loss, short-term medical, occupational accident, and other coverages); aviation; our London market account (which includes energy, property, marine, and accident and health coverages); and other specialty lines of insurance (which includes public entity, U.K. liability, event cancellation, contingency, and other coverages). We operate primarily in the United States, the United Kingdom, Spain and Ireland, although some of our operations have a broader international scope.

Our principal domestic insurance companies are Houston Casualty Company and U.S. Specialty Insurance Company, HCC Life Insurance Company, Avemco Insurance Company, American Contractors Indemnity Company and United States Surety Company. These companies operate throughout the United States with headquarters in Houston, Texas; Atlanta, Georgia; Frederick, Maryland; Los Angeles, California; and Timonium, Maryland, respectively. All of our principal domestic insurance companies operate on an admitted basis, except Houston Casualty Company, which also insures international risks. Our foreign insurance companies are HCC International Insurance Company, HCC Europe, HCC Reinsurance Company and the London branch of Houston Casualty Company. These companies operate principally from the United Kingdom and Spain. We also participate in two Lloyd s of London syndicates, Syndicate 4040 and Syndicate 4141, which operate in London, England.

Our underwriting agencies provide underwriting management and claims servicing for insurance and reinsurance companies in specialized lines of business within the property and casualty and group life, accident and health insurance sectors. Our principal domestic agencies are Professional Indemnity Agency, HCC Global Financial Products, HCC Specialty Underwriters, HCC Indemnity Guaranty Agency, HCC Medical Insurance Services, LLC, RA&MCO Insurance Services and G.B. Kenrick & Associates. Our agencies operate throughout the United States. Our principal foreign agencies are HCC Global Financial Products, with headquarters in Barcelona, Spain, and HCC Underwriting Agency, Ltd. (UK), which manages our syndicates and operates in London, England.

### *Basis of Presentation*

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles or GAAP) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Management must make estimates and assumptions that affect amounts reported in our consolidated financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates.

We have reclassified certain amounts in our 2008 and 2007 consolidated financial statements to conform to the 2009 presentation. None of our reclassifications had an effect on our consolidated net earnings, shareholders equity or cash flows.

**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

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***Net Earned Premium, Policy Acquisition Costs and Ceding Commissions***

Substantially all of the property and casualty, surety, and accident and health policies written by our insurance companies qualify as short-duration contracts. We recognize in current earned income the portion of the premium that provides insurance protection in the period. For the majority of our insurance policies, we recognize premium, net of reinsurance, on a pro rata basis over the term of the related contract. For certain directors and officers liability tail policies, surety bonds and energy construction contracts, we recognize premium, net of reinsurance, over the period of risk in proportion to the amount of insurance protection provided. Unearned premium represents the portion of premium written that relates to the unexpired period of protection. Premium for commercial title insurance and group life policies is recognized in earnings when the premium is due. When the limit under a specific excess of loss reinsurance layer has been exhausted, we effectively expense the remaining premium for that limit and defer and amortize the reinstatement premium over the remaining period of risk.

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

***Fee and Commission Income***

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

When our underwriting agencies utilize one of our insurance company subsidiaries as the policy issuing company, we eliminate in consolidation the fee and commission income against the related insurance company s policy acquisition costs and defer the policy acquisition costs of the underwriting agencies.

***Premium, Claims and Other Receivables***

We use the gross method for reporting receivables and payables on brokered transactions. We review the collectibility of our receivables on a current basis and provide an allowance for doubtful accounts if we deem that there are accounts that are doubtful of collection. The allowance was $4.3 million and $5.4 million at December 31, 2009 and 2008, respectively. Our estimate of the level of the allowance could change as conditions change in the future.

***Loss and Loss Adjustment Expense Payable***

Loss and loss adjustment expense payable by our insurance companies is based on estimates of payments to be made for reported losses, incurred but not reported losses, and anticipated receipts from salvage and subrogation. Reserves are recorded on an undiscounted basis, except for reserves of acquired companies. The

**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

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discount on those reserves is not material. Estimates for reported losses are based on all available information, including reports received from ceding companies on assumed business. Estimates for incurred but not reported losses are based both on our experience and the industry s experience. While we believe that amounts included in our consolidated financial statements are adequate, such estimates may be more or less than the amounts ultimately paid when the claims are settled. We continually review the estimates with our actuaries, and any changes are reflected in loss and loss adjustment expense in the period of the change.

***Reinsurance***

We record all reinsurance recoverables and ceded unearned premium as assets, and deferred ceding commissions as liabilities. All such amounts are recorded in a manner consistent with the underlying reinsured contracts. We record a reserve for uncollectible reinsurance based on our assessment of reinsurers credit worthiness, reinsurance contract terms and collectibility. Information utilized to calculate the reserve is subject to change, which could affect the level of the reserve in the future.

One assumed residential mortgage guaranty reinsurance contract, which we determined did not transfer significant underwriting risk, was accounted for using the deposit method of accounting since inception in 2008. We commuted this reinsurance contract in 2009. We recorded all consideration received under the contract, prior to the commutation, as a deposit liability, rather than as net earned premium. We reported income from this contract as other operating income in our consolidated statements of earnings.

***Cash and Short-term Investments***

Cash consists of cash in banks, generally in operating accounts. Short-term investments, including certificates of deposit and money-market funds, are classified as investments in our consolidated balance sheets as they relate principally to our investment activities. We generally maintain our cash deposits in major banks and invest our short-term funds in institutional money-market funds and short-term financial instruments. These securities typically mature within ninety days and, therefore, bear minimal risk.

Certain fiduciary funds totaling $284.2 million and $271.9 million were included in short-term investments and fixed income securities at December 31, 2009 and 2008, respectively. These funds are held for the benefit of our clients. We earn interest, net of expenses, on these funds.

***Restricted Cash and Cash Investments***

Our agencies hold funds of unaffiliated parties for the payment of claims and our surety businesses hold funds as collateral for potential claims. These funds are shown as restricted cash and cash investments in our consolidated balance sheets. The corresponding liability is included within either premium and claims payable or accounts payable and accrued expenses in our consolidated balance sheets. These amounts are considered fiduciary funds, and interest earned on these funds accrues to the benefit of the parties from whom the funds were withheld. Therefore, we do not include these amounts as cash in our consolidated statements of cash flows.

***Investments***

Substantially all of our fixed income securities are classified as available for sale and reported at fair value. In determining fair value, we apply the market approach, which uses quoted prices or other relevant data based on market transactions involving identical or comparable assets. The change in unrealized gain or loss on available for sale securities is recorded as a component of other comprehensive income, net of the related deferred income tax effect, within our consolidated shareholders equity. For securities denominated in currencies other than the U.S. dollar, the foreign exchange gain/loss on available for sale securities is recorded

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as a component of accumulated other comprehensive income until the related securities mature or are sold. We purchase the majority of our available for sale fixed income securities with the intent to hold them to maturity, but they may be sold prior to maturity if market conditions or credit-related risk warrant or if our investment policies dictate in order to maximize our investment yield.

Our available for sale fixed income portfolio includes asset-backed and mortgage-backed securities for which we recognize income using a constant effective yield based on anticipated prepayments and the estimated economic life of the securities. When actual prepayments differ significantly from anticipated prepayments, the estimated economic life is recalculated and the remaining unamortized premium or discount is amortized prospectively over the remaining economic life.

A small portion of our fixed income securities are classified as held to maturity and reported at amortized cost. This portfolio includes securities, denominated in currencies other than the functional currency of the subsidiary, for which we have the ability and intent to hold the securities to maturity or redemption. We hold these securities to hedge the foreign exchange risk associated with insurance claims and liabilities that we will pay in those currencies. Any foreign exchange gain/loss on these securities is recorded through income and substantially offsets any foreign exchange gain/loss on the related liabilities.

Short-term investments and restricted cash investments are carried at cost, which approximates fair value.

Other investments previously included alternative investments, which were accounted for using the equity method of accounting, and trading securities, which were carried at fair value. We completed the liquidation of our alternative investments in 2009 and our trading securities in 2008. The value of our alternative investments at December 31, 2008 was $46.0 million. Changes in carrying value are included in the consolidated statements of earnings within net investment income for other alternative investments and in other operating income for trading securities.

Realized investment gains or losses are determined on an average cost basis and included in earnings on the trade date.

***Other-than-temporary Impairments***

A security has an impairment loss when its fair value is less than its cost or amortized cost at the balance sheet date. We evaluate impaired securities in our fixed income securities portfolio for possible other-than-temporary impairment losses at each quarter end. Beginning April 1, 2009, we adopted a new accounting standard that specified new criteria for indentifying and recognizing an other-than-temporary impairment loss. Our current evaluation considers various factors including:

amount by which the security s fair value is less than its cost,

length of time the security has been impaired,

whether we intend to sell the security,

if it is more likely than not that we will have to sell the security before recovery of its amortized cost basis,

whether the impairment is due to an issuer-specific event, credit issues or change in market interest rates,

the security s credit rating and any recent downgrades, and

stress testing of expected cash flows under various scenarios.

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For each impaired fixed income security, we determine: 1) we do not intend to sell the security and 2) it is more likely than not that we will not be required to sell the security before recovery of its amortized cost basis. If we cannot assert these conditions, we record an other-than-temporary impairment loss through our consolidated statement of earnings in the current period. For all other impaired securities, we assess whether the net present value of the cash flows expected to be collected from the security is less than its amortized cost basis. Such a shortfall in cash flows is referred to as a credit loss. For any such security, we separate the impairment loss into: 1) the credit loss and 2) the amount related to all other factors, such as interest rate changes, market conditions, etc. (the non-credit loss). We charge the credit loss to current period earnings and the non-credit loss to other comprehensive income, within shareholders equity, on an after-tax basis. A security s cost basis is permanently reduced by the amount of a credit loss. We accrete income over the remaining life of the security based on the interest rate necessary to discount the expected future cash flows to the new basis. If the security is non-income producing, we apply any cash proceeds as a reduction of principal when received.

Prior to April 1, 2009, we assessed our ability and intent to hold an impaired security for a period of time sufficient to allow full recovery or until maturity. If we could not assert this condition, we recorded the difference between fair value and amortized cost as an other-than-temporary impairment loss through earnings in that period.

***Derivative Financial Instruments***

We have reinsured interests in two long-term mortgage impairment insurance contracts that are denominated in British pound sterling. The exposure with respect to these two contracts is measured based on movement in a specified United Kingdom housing index. These insurance contracts qualify as derivative financial instruments, are unhedged and are reported in other assets at fair value in our consolidated balance sheets. We determine fair value based on our estimate of the present value of expected future cash flows, modified to reflect specific contract terms. We record changes in fair value and any foreign exchange gain/loss on these contracts as a component of other operating income in our consolidated statements of earnings. During 2009, we collected $20.3 million of cash on these contracts. At December 31, 2009 and 2008, the fair value was $0.4 million (after reduction for the cash received) and $16.1 million, respectively.

We have two free standing interest rate swap agreements that we originally purchased to convert outstanding borrowings on our Revolving Loan Facility from a variable rate to a fixed rate through November 2010. We repaid our Revolving Loan Facility in 2009. These swap agreements are recorded at fair value and reported in accounts payable and accrued expenses. The change in fair value is recorded as a component of other operating expense in our consolidated statements of earnings.

From 2007 to 2009, we had interest rate swap agreements that converted outstanding borrowings on our Revolving Loan Facility from a variable rate to a fixed rate. These agreements qualified for hedge accounting treatment as cash flow hedges, with the change in fair value recorded through other comprehensive income, until their maturity in November 2009.

***Strategic Investments and Other Operating Income***

Prior to December 31, 2009, we had certain strategic investments in insurance-related companies recorded in other assets in the consolidated balance sheets. For any strategic investment in which we owned a 20% to 50% equity interest, the investment and income were recorded using the equity method of accounting. The related income was reported in other operating income in the consolidated statements of earnings. We recorded any interest, dividends on investments not accounted for by the equity method of accounting, and realized gains or losses in other operating income.

**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

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***Goodwill and Intangible Assets***

When we complete a business combination, goodwill is either allocated to the reporting unit in which the acquired business is included or, if there are synergies with our other businesses, allocated to the different reporting units based on their respective share of the estimated future cash flows. In our insurance company segment, the reporting units are either individual subsidiaries or groups of subsidiaries that share common licensing and other characteristics. In our agency segment, the reporting units are individual subsidiaries.

To determine the fair value of each reporting unit, we consider three valuation approaches (market, income and cost). Generally, we utilize the market and income approaches and base our assumptions and inputs on market participant data, rather than our own data. For the income approach, we estimate the present value of expected cash flows to determine the fair value of each reporting unit. We utilize estimated future cash flows, probabilities as to occurrence of these cash flows, a risk-free rate of interest, and a risk premium for uncertainty in the cash flows. We weight the results of the market and income approaches to determine the calculated fair value of each reporting unit. We utilize our budgets and projection of future operations based on historical and expected industry trends to estimate our future cash flows and their probability of occurring as projected.

An indicator of impairment of goodwill exists when the fair value of a reporting unit is less than its carrying amount. We assess our goodwill for impairment annually, or sooner if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. We conducted our 2009 goodwill impairment test as of June 30, 2009, which is consistent with the time frame for our annual assessment in prior years. Based on our latest impairment test, the fair value of each of our reporting units exceeded its carrying amount. No events have occurred that indicate there is an impairment in our goodwill as of December 31, 2009.

Intangible assets not subject to amortization are tested for impairment annually, or sooner if an event occurs or circumstances change that indicate that an intangible asset might be impaired. Other intangible assets are amortized over their respective useful lives.

***Foreign Currency***

The functional currency of some of our foreign subsidiaries and branches is the U.S. dollar. Transactions in foreign currencies, principally the British pound sterling and the Euro, are translated at the rates of exchange in effect on the date the transaction occurs. Transaction gains and losses are recorded in earnings and included in other operating expense in the consolidated statements of earnings. Assets and liabilities recorded in foreign currencies are translated into U.S. dollars at exchange rates in effect at the balance sheet date.

For available for sale securities, unrealized gains and losses related to fluctuations in exchange rates are recorded as a component of other comprehensive income, net of the related deferred income tax effect, within shareholders equity until the securities mature or are sold. Similar exchange rate fluctuations related to held to maturity securities are recorded through income.

We utilize the British pound sterling and the Euro as the functional currency in certain of our foreign operations. The cumulative translation adjustment, representing the effect of translating these subsidiaries assets and liabilities into

U.S. dollars, is included in the foreign currency translation adjustment, net of the related deferred income tax effect, within accumulated other comprehensive income in shareholders equity.

The effect of exchange rate changes on cash balances held in foreign currencies was immaterial for all periods presented and is not shown separately in the consolidated statements of cash flows.

**HCC INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

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***Income Taxes***

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

In 2007, we adopted a new accounting standard related to uncertain tax positions and reduced beginning retained earnings by $0.7 million, primarily for potential interest on previously recorded tax liabilities related to uncertain tax positions. We maintain a liability for our uncertain tax positions where we determine it is not more likely than not the tax position will be sustained upon examination by the appropriate tax authority. Changes in the liability for our uncertain tax positions are reflected in income tax expense in the period when a new uncertain tax position arises, we change our judgment about the likelihood of uncertainty, the tax issue is settled, or the statute of limitations expires. We report any potential net interest income or expense and penalties related to changes in our uncertain tax positions in our consolidated statements of earnings as interest expense and other operating expense, respectively.

***Stock-Based Compensation***

For stock option awards, we use the Black-Scholes single option pricing model to determine the fair value of an option on its grant date and expense that value on a straight-line basis over the option s vesting period. For grants of restricted stock and restricted stock units, we measure fair value based on our closing stock price on the grant date and expense that value on a straight-line basis over the award s vesting period. For grants of unrestricted common stock, we measure fair value based on our closing stock price on the grant date and expense that value on the grant date.

***Earnings Per Share***

Basic earnings per share is computed by dividing net earnings attributable to common stock by the weighted-average common shares outstanding during the year. Diluted earnings per share is computed by dividing net earnings attributable to common stock by the weighted-average common shares outstanding plus the weighted-average potential common shares outstanding during the year. Outstanding common stock options, when dilutive, are included in the weighted-average potential common shares outstanding. Also included are common shares that would be issued for any premium in excess of the principal amount of our convertible debt. We use the treasury stock method to calculate the dilutive effect of potential common shares outstanding. We treat unvested restricted stock and unvested restricted stock units that contain non-forfeitable rights to dividends or dividend-equivalents as participating securities and include them in the earnings allocation in calculating earnings per share under the two-class method.

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***Accounting Guidance Adopted in 2009***

*Codification*

In 2009, the Accounting Standards Codification (ASC or the Codification) issued by the Financial Accounting Standards Board (FASB) became the single authoritative source of U.S. GAAP. Rules and interpretive releases issued by the Securities and Exchange Commission (SEC) are the only other source of U.S. GAAP for SEC registrants. Although the Codification renames and renumbers all previous accounting literature, it does not change current U.S. GAAP. Our accounting policies were not affected by our adoption and usage of the Codification.

*Convertible Debt*

A new accounting standard, originally issued as FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement),* became effective January 1, 2009 and required retrospective application to prior financial statements. This change to ASC Topic 470, *Debt*, clarifies that convertible debt instruments that may be settled in cash upon conversion are not totally debt, and requires issuers to bifurcate and separately account for the liability and equity components. We retrospectively adjusted our consolidated financial statements for all periods prior to 2009 to reflect the bifurcation of the debt and equity components of our 1.30% and 2.00% Convertible Notes. We included the retrospectively adjusted financial statements and related disclosures in our Form 8-K filed with the SEC on November 9, 2009. Our adoption of this guidance did not impact our past or current consolidated cash flows.

*Fair Value Measurements*

A new accounting standard, originally issued as FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, became effective January 1, 2009. This guidance requires prospective application of ASC Topic 820, *Fair Value Measurement and Disclosure*, to nonfinancial assets and nonfinancial liabilities measured at fair value on a nonrecurring basis, such as goodwill. Our adoption of this revised guidance had no impact on our consolidated financial statements.

New accounting standards, originally issued as FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that Are Not Orderly;* FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments;* and FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-than-temporary Impairments,* became effective prospectively on April 1, 2009. These changes to ASC Topic 820, *Fair Value Measurements and Disclosures*, and ASC Topic 320, *Investments Debt and Equity Securities*, modify the accounting guidance for determining fair value of financial instruments under distressed market conditions, revise the recognition and measurement requirements for other-than-temporary impairment losses on debt securities and expand the related disclosures. Our adoption of this guidance did not have a material effect on our 2009 consolidated financial statements.

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*Earnings per Share*

A new accounting standard, originally issued as FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities*, became effective January 1, 2009 and required retrospective application to prior periods. This change to ASC Topic 260, *Earnings Per Share*, clarifies whether instruments granted in share-based payments, such as restricted stock, are participating securities prior to vesting and, therefore, must be included in the earnings allocation in calculating earnings per share under the two-class method described in ASC Topic 260-10-45-59A, *Participating Securities and the Two-Class Method*. As revised, ASC Topic 260 requires that unvested share-based payments that contain non-forfeitable rights to dividends or dividend-equivalents are treated as participating securities. Our adoption of this guidance had no material impact on our consolidated earnings per share in any prior period due to immateriality of our restricted stock awards that have such terms.

*Business Combinations*

A new accounting standard, originally issued as SFAS No. 141 (revised 2007), *Business Combinations*, became effective January 1, 2009. This change to ASC Topic 805, *Business Combinations*, modifies certain accounting treatment for business combinations and impacts presentation of financial statements on the acquisition date and accounting for acquisitions in subsequent periods. We recorded all new acquisitions in 2009 in accordance with this guidance.

*Consolidation*

A new accounting standard, originally issued as SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, *an amendment of Accounting Research Bulletin No. 51*, became effective January 1, 2009. This change to ASC Topic 810, *Consolidation*, modifies the accounting and reporting for minority interests, which are now recharacterized as noncontrolling interests and classified as a component of shareholders equity. Our adoption of this guidance had no impact on our consolidated financial statements.

*Derivatives*

A new accounting standard, originally issued as SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133,* became effective January 1, 2009. This change to ASC Topic 815, *Derivatives and Hedging*, expands the required disclosures about a company s derivative and hedging activities. Our adoption had no impact on our consolidated financial statements.

***Recent Accounting Guidance***

A new accounting standard, originally issued as SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, was issued in June 2009. The guidance, which will be incorporated into ASC Topic 810, *Consolidation*, changes various aspects of accounting for and disclosures of interests in variable interest entities. We will adopt the guidance effective January 1, 2010. Our adoption of this guidance will not have a material impact on our consolidated financial statements.

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## (2) Fair Value Measurements

We value financial assets and financial liabilities at fair value. In determining fair value, we generally apply the market approach, which uses prices and other relevant data based on market transactions involving identical or comparable assets and liabilities. We classify our financial instruments into the following three-level hierarchy:

Level 1 Inputs are based on quoted prices in active markets for identical instruments.

Level 2 Inputs are based on observable market data (other than quoted prices), or are derived from or corroborated by observable market data.

Level 3 Inputs are unobservable and not corroborated by market data.

Our Level 1 investments are primarily U.S. Treasuries listed on stock exchanges. We use quoted prices for identical instruments to measure fair value.

Our Level 2 investments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities, and certain mortgage-backed and asset-backed securities. Our Level 2 instruments also include our interest rate swap agreements, which were reflected as liabilities in our consolidated balance sheet at December 31, 2009. We measure fair value for the majority of our Level 2 investments using quoted prices of securities with similar characteristics. The remaining investments are valued using pricing models or matrix pricing. The fair value measurements consider observable assumptions, including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, default rates, loss severity and other economic measures.

We use independent pricing services to assist us in determining fair value for over 99% of our Level 1 and Level 2 investments. The pricing services provide a single price or quote per security. We use data provided by our third party investment manager to value the remaining Level 2 investments. To validate that these quoted and modeled prices are reasonable estimates of fair value, we perform various quantitative and qualitative procedures, including: 1) evaluation of the underlying methodologies, 2) analysis of recent sales activity, 3) analytical review of our fair values against current market prices, and 4) comparison of the pricing services fair value to other pricing services fair value for the same investment. Based on these procedures, we did not adjust the prices or quotes provided by our independent pricing services or third party investment managers as of December 31, 2009 or 2008. In addition, we did not apply GAAP criteria for determining the fair value of securities in inactive markets since no markets for our investments were judged to be inactive as of December 31, 2009 and 2008.

Our Level 3 securities include certain fixed income securities and two insurance contracts that we account for as derivatives. We determine fair value based on internally developed models that use assumptions or other data that are not readily observable from objective sources. Because we use the lowest level significant input to determine our hierarchy classifications, a financial instrument may be classified in Level 3 even though there may be significant readily-observable inputs.

We excluded from our fair value disclosures our held to maturity investment portfolio measured at amortized cost and two other investments measured at cost. Our held to maturity portfolio had a fair value of $104.0 million at December 31, 2009 and $125.6 million at December 31, 2008. The two other investments collectively were valued at $4.1 million at December 31, 2009 and 2008.

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The following tables present our assets and liabilities that were measured at fair value. Substantially all of our fixed income securities in Level 3 at December 31, 2009 and 2008 were commercial mortgage-backed and asset-backed securities.

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| December 31, 2009 | | | | |
| Fixed income securities | $ 178,927 | $ 4,354,884 | $ 4,262 | $ 4,538,073 |
| Other investments | 14 | | | 14 |
| Other assets | | | 432 | 432 |
| **Total assets measured at fair value** | $ 178,941 | $ 4,354,884 | $ 4,694 | $ 4,538,519 |
| Accounts payable and accrued liabilities | $ | $ (2,367) | $ | $ (2,367) |
| **Total liabilities measured at fair value** | $ | $ (2,367) | $ | $ (2,367) |
| December 31, 2008 | | | | |
| Fixed income securities | $ 87,678 | $ 4,038,972 | $ 6,515 | $ 4,133,165 |
| Other investments | 16 | | | 16 |
| Other assets | | 1,125 | 16,100 | 17,225 |
| **Total assets measured at fair value** | $ 87,694 | $ 4,040,097 | $ 22,615 | $ 4,150,406 |
| Accounts payable and accrued liabilities | $ | $ (8,031) | $ | $ (8,031) |
| **Total liabilities measured at fair value** | $ | $ (8,031) | $ | $ (8,031) |

The following table pre-bottom:3px double #000000;padding-left:2px;padding-top:2px;padding-bottom:2px;">
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%

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(1) Unpaid principal balance represents the contractual obligation due from the customer and includes the net book value plus charge-offs and payments applied.
(2) Charge-offs and payments applied represents cumulative partial charge-offs taken, as well as interest payments received that have been applied against the outstanding principal balance.
(3) Book value represents the unpaid principal balance less charge-offs and payments applied; it is shown before any allowance for loan losses.
(4) Coverage % represents charge-offs and payments applied plus the related allowance as a percent of the unpaid principal balance.

The following table presents the average balances of total impaired loans and interest income for the three months ended March 31, 2015 and 2014. Interest income recognized represents interest on accruing loans modified in a TDR. TDRs are considered impaired loans.

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| | Three Months Ended March 31 | | | |
|---|---|---|---|---|
| | 2015 | | 2014 | |
| | Average Balance | Interest Income Recognized | Average Balance | Interest Income Recognized |
| | (In millions) | | | |
| Commercial and industrial | $359 | $1 | $467 | $3 |
| Commercial real estate mortgage—owner-occupied | 379 | 3 | 511 | 4 |
| Commercial real estate construction—owner-occupied | 3 | — | 41 | — |
| Total commercial | 741 | 4 | 1,019 | 7 |
| Commercial investor real estate mortgage | 331 | 3 | 620 | 8 |
| Commercial investor real estate construction | 33 | 1 | 87 | 1 |
| Total investor real estate | 364 | 4 | 707 | 9 |
| Residential first mortgage | 476 | 4 | 457 | 4 |
| Home equity | 363 | 5 | 387 | 5 |
| Indirect | 1 | — | 1 | — |
| Consumer credit card | 2 | — | 2 | — |
| Other consumer | 15 | — | 24 | — |
| Total consumer | 857 | 9 | 871 | 9 |
| Total impaired loans | $1,962 | $17 | $2,597 | $25 |

In addition to the impaired loans detailed in the tables above, there were approximately $32 million in non-performing loans classified as held for sale at March 31, 2015, compared to $38 million at December 31, 2014. The loans are carried at an amount approximating a price which is expected to be recoverable through the loan sale market. During the three months ended March 31, 2015 and 2014, approximately $12 million and $15 million, respectively, in non-performing loans were transferred to held for sale; these amounts are net of charge-offs of $7 million and $8 million, respectively, recorded upon transfer. At March 31, 2015 and December 31, 2014, non-accrual loans including loans held for sale totaled $832 million and $867 million, respectively.

TROUBLED DEBT RESTRUCTURINGS

Regions regularly modifies commercial and investor real estate loans in order to facilitate a workout strategy. Typical modifications include accommodations, such as renewals and forbearances. The majority of Regions’ commercial and investor real estate TDRs are the result of renewals of classified loans at an interest rate that is not considered to be a market interest rate. For smaller dollar commercial loans, Regions may periodically grant interest rate and other term concessions, similar to those under the consumer program described below.

Regions works to meet the individual needs of consumer borrowers to stem foreclosure through the Customer Assistance Program ("CAP"). Regions designed the program to allow for customer-tailored modifications with the goal of keeping customers in their homes and avoiding foreclosure where possible. Modification may be offered to any borrower experiencing financial hardship regardless of the borrower’s payment status. Consumer TDRs primarily involve an interest rate concession, however under the CAP, Regions may also offer a short-term deferral, a term extension, a new loan product, or a combination of these options. For loans restructured under the CAP, Regions expects to collect the original contractually due principal. The gross original contractual interest may be collectible, depending on the terms modified. The length of the CAP modifications ranges from temporary payment deferrals of three months to term extensions for the life of the loan. All such modifications are considered TDRs regardless of the term because they are concessionary in nature and because the customer documents a hardship in order to participate.

As noted above, the majority of Regions’ TDRs are the result of interest rate concession and not a forgiveness of principal. Accordingly, the financial impact of the modifications is best illustrated by the impact to the allowance calculation at the loan or pool level, as a result of the loans being considered impaired due to their TDR status. Regions most often does not record a charge-off at the modification date.

None of the modified consumer loans listed in the following TDR disclosures were collateral-dependent at the time of modification. At March 31, 2015, approximately $58 million in residential first mortgage TDRs were in excess of 180 days past due and were considered collateral-dependent. At March 31, 2015, approximately $8 million in home equity first lien TDRs were in excess of 180 days past due and approximately $5 million in home equity second lien TDRs were in excess of 120 days past due, both of which were considered collateral-dependent.

Further discussion related to TDRs, including their impact on the allowance for loan losses and designation of TDRs in periods subsequent to the modification is included in Note 1 in the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2014.

The following tables present the end of period balance for loans modified in a TDR during the periods presented by portfolio segment and class, and the financial impact of those modifications. The tables include modifications made to new TDRs, as well as renewals of existing TDRs. The end of period balance, for the period in which it was added, of total loans first reported as new TDRs totaled approximately $107 million and $121 million for the three months ended March 31, 2015 and 2014, respectively.

| | Three Months Ended March 31, 2015 | | |
|---|---|---|---|
| | Number of Obligors | Recorded Investment | Financial Impact of Modifications Considered TDRs Increase in Allowance at Modification |
| | (Dollars in millions) | | |
| Commercial and industrial | 41 | $57 | $1 |
| Commercial real estate mortgage—owner-occupied | 42 | 25 | 1 |
| Total commercial | 83 | 82 | 2 |
| Commercial investor real estate mortgage | 29 | 24 | 1 |
| Commercial investor real estate construction | 1 | 1 | — |
| Total investor real estate | 30 | 25 | 1 |
| Residential first mortgage | 133 | 32 | 4 |
| Home equity | 125 | 6 | — |
| Consumer credit card | 32 | — | — |
| Indirect and other consumer | 87 | 1 | — |
| Total consumer | 377 | 39 | 4 |
| | 490 | $146 | $7 |

| | Three Months Ended March 31, 2014 | | |
|---|---|---|---|
| | Number of Obligors | Recorded Investment | Financial Impact of Modifications Considered TDRs Increase in Allowance at Modification |
| | (Dollars in millions) | | |
| Commercial and industrial | 91 | $94 | $— |
| Commercial real estate mortgage—owner-occupied | 85 | 70 | 1 |
| Commercial real estate construction—owner-occupied | 1 | 1 | — |
| Total commercial | 177 | 165 | 1 |
| Commercial investor real estate mortgage | 98 | 107 | — |
| Commercial investor real estate construction | 15 | 7 | — |
| Total investor real estate | 113 | 114 | — |
| Residential first mortgage | 125 | 24 | 4 |
| Home equity | 154 | 10 | — |
| Consumer credit card | 32 | — | — |
| Indirect and other consumer | 51 | 1 | — |
| Total consumer | 362 | 35 | 4 |
| | 652 | $314 | $5 |

Defaulted TDRs

The following table presents by portfolio segment and class TDRs that defaulted during the three months ended March 31, 2015 and 2014, and that were modified in the previous twelve months (i.e., the twelve months prior to the default). For purposes of this disclosure, default is defined as 90 days past due and still accruing for the consumer portfolio segment, and placement on non-accrual status for the commercial and investor real estate portfolio segments. Consideration of defaults in the calculation of the allowance for loan losses is described in detail in the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2014.

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| | Three Months Ended March 31 | |
|---|---|---|
| | 2015 | 2014 |
| | (In millions) | |
| Defaulted During the Period, Where Modified in a TDR Twelve Months Prior to Default | | |
| Commercial and industrial | $1 | $42 |
| Commercial real estate mortgage—owner-occupied | 1 | 3 |
| Total commercial | 2 | 45 |
| Commercial investor real estate mortgage | 1 | 2 |
| Commercial investor real estate construction | — | 1 |
| Total investor real estate | 1 | 3 |
| Residential first mortgage | 3 | 9 |
| Home equity | — | 1 |
| Total consumer | 3 | 10 |
| | $6 | $58 |

Commercial and investor real estate loans that were on non-accrual status at the time of the latest modification are not included in the default table above, as they are already considered to be in default at the time of the restructuring. At March 31, 2015, approximately $28 million of commercial and investor real estate loans modified in a TDR during the three months ended March 31, 2015 were on non-accrual status. Approximately 1.4 percent of this amount was 90 days past due.

At March 31, 2015, Regions had restructured binding unfunded commitments totaling $99 million where a concession was granted and the borrower was in financial difficulty.

NOTE 5. SERVICING OF FINANCIAL ASSETS

RESIDENTIAL MORTGAGE BANKING ACTIVITIES

The fair value of residential mortgage servicing rights is calculated using various assumptions including future cash flows, market discount rates, expected prepayment rates, servicing costs and other factors. A significant change in prepayments of mortgages in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of residential mortgage servicing rights. The Company compares fair value estimates and assumptions to observable market data where available, and also considers recent market activity and actual portfolio experience.

The table below presents an analysis of residential mortgage servicing rights under the fair value measurement method:

| | Three Months Ended March 31 | |
|---|---|---|
| | 2015 | 2014 |
| | (In millions) | |
| Carrying value, beginning of period | $257 | $297 |
| Additions | 7 | 8 |
| Increase (decrease) in fair value[(1)]: | | |
| Due to change in valuation inputs or assumptions | (17) | (10) |
| Economic amortization associated with borrower repayments | (8) | (7) |
| Carrying value, end of period | $239 | $288 |

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(1) "Economic amortization associated with borrower repayments" includes both total loan payoffs as well as partial paydowns. Prior to the fourth quarter of 2014, this line item reflected total loan payoffs only, while partial paydowns were included in the "Due to change in valuation inputs or assumptions" line item. The 2014 three months ended amount disclosed in the table has been reclassified to reflect the revised presentation.

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Data and assumptions used in the fair value calculation, as well as the valuation's sensitivity to rate fluctuations, related to residential mortgage servicing rights (excluding related derivative instruments) are as follows:

| | March 31 | | | |
|---|---|---|---|---|
| | 2015 | | 2014 | |
| | (Dollars in millions) | | | |
| Unpaid principal balance | $26,903 | | $27,785 | |
| Weighted-average prepayment speed (CPR; percentage) | 12.7 | % | 9.3 | % |
| Estimated impact on fair value of a 10% increase | $(14 | ) | $(12 | ) |
| Estimated impact on fair value of a 20% increase | $(27 | ) | $(23 | ) |
| Option-adjusted spread (basis points) | 1,006 | | 880 | |
| Estimated impact on fair value of a 10% increase | $(9 | ) | $(9 | ) |
| Estimated impact on fair value of a 20% increase | $(18 | ) | $(18 | ) |
| Weighted-average coupon interest rate | 4.4 | % | 4.5 | % |
| Weighted-average remaining maturity (months) | 279 | | 279 | |
| Weighted-average servicing fee (basis points) | 27.8 | | 27.7 | |

The sensitivity calculations above are hypothetical and should not be considered to be predictive of future performance. Changes in fair value based on adverse changes in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, the effect of an adverse variation in a particular assumption on the fair value of the residential mortgage servicing rights is calculated without changing any other assumption, while in reality changes in one factor may result in changes in another, which may either magnify or counteract the effect of the change. The derivative instruments utilized by Regions would serve to reduce the estimated impacts to fair value included in the table above.

The following table presents servicing related fees, which includes contractually specified servicing fees, late fees and other ancillary income resulting from the servicing of residential mortgage loans:

| | Three Months Ended March 31 | |
|---|---|---|
| | 2015 | 2014 |
| | (In millions) | |
| Servicing related fees and other ancillary income | $20 | $21 |

Residential mortgage loans are sold in the secondary market with standard representations and warranties regarding certain characteristics such as the quality of the loan, the absence of fraud, the eligibility of the loan for sale and the future servicing associated with the loan. Regions may be required to repurchase these loans at par, or make-whole or indemnify the purchasers for losses incurred when representations and warranties are breached.

Regions maintains a repurchase liability related to residential mortgage loans sold with representations and warranty provisions. This repurchase liability is reported in other liabilities on the consolidated balance sheets and reflects management's estimate of losses based on historical repurchase and loss trends, as well as other factors that may result in anticipated losses different from historical loss trends. Adjustments to this reserve are recorded in other non-interest expense on the consolidated statements of income. The table below presents an analysis of Regions' repurchase liability related to residential mortgage loans sold with representations and warranty provisions:

| | Three Months Ended March 31 | | | |
|---|---|---|---|---|
| | 2015 | | 2014 | |
| | (In millions) | | | |
| Beginning balance | $26 | | $39 | |
| Additions (reductions), net | 1 | | 3 | |
| Losses | (1 | ) | (3 | ) |
| Ending balance | $26 | | $39 | |

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COMMERCIAL MORTGAGE BANKING ACTIVITIES

On July 18, 2014, Regions was approved as a Fannie Mae Delegated Underwriting and Servicing ("DUS") lender and acquired a DUS servicing portfolio totaling approximately $1.0 billion. The Fannie Mae DUS program provides liquidity to the multi-family housing market. As part of the transaction, Regions recorded $12 million in commercial mortgage servicing rights accounted for under the amortization method and $15 million in intangible assets associated with the DUS license purchased. Regions also assumed a one-third loss share guarantee associated with the purchased portfolio and any future originations. Regions estimated the fair value of the loss share guarantee to be approximately $4 million. See Note 1 "Summary of Significant Accounting Policies" in the 2014 Annual Report on Form 10-K for additional information.

As of March 31, 2015, the DUS servicing portfolio remained at approximately $1.0 billion, the related commercial mortgage servicing rights were valued at approximately $11 million, and the loss share guarantee was valued at approximately $3 million.

NOTE 6. GOODWILL

Goodwill allocated to each reportable segment (each a reporting unit) is presented as follows:

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (In millions) | |
| Corporate Bank | $2,258 | $2,258 |
| Consumer Bank | 2,095 | 2,095 |
| Wealth Management | 463 | 463 |
| | $4,816 | $4,816 |

Regions evaluates each reporting unit’s goodwill for impairment on an annual basis in the fourth quarter, or more often if events or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. A detailed description of the Company's methodology and valuation approaches used to determine the estimated fair value of each reporting unit is included in the consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2014. Adverse changes in the economic environment, declining operations, or other factors could result in a decline in the implied fair value of goodwill.

During the first quarter of 2015, Regions assessed events and circumstances for all three reporting units as of March 31, 2015 and through the date of the filing of this Quarterly Report on Form 10-Q that could potentially indicate goodwill impairment. The indicators assessed included:

- Recent operating performance,
- Changes in market capitalization,
- Regulatory actions and assessments,
- Changes in the business climate (including legislation, legal factors, and competition),
- Company-specific factors (including changes in key personnel, asset impairments, and business dispositions), and
- Trends in the banking industry.

Results of the 2014 annual test indicated that the estimated fair value of each reporting unit exceeded its carrying amount as of the test date. Additionally, after assessing the indicators noted above, Regions determined that it was not more likely than not that the fair value of each of its reporting units had declined below their carrying values as of March 31, 2015. Therefore, Regions determined that a test of goodwill impairment was not required for each of Regions’ reporting units for the March 31, 2015 interim period.

NOTE 7. STOCKHOLDERS’ EQUITY AND ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

PREFERRED STOCK

The following table presents a summary of the non-cumulative perpetual preferred stock:

| | | | | | | March 31, 2015 | December 31, 2014 |
|---|---|---|---|---|---|---|---|
| | Issuance Date | Earliest Redemption Date | Dividend Rate | | Liquidation Amount | Carrying Amount | Carrying Amount |
| | (Dollars in millions) | | | | | | |
| Series A | 11/1/2012 | 12/15/2017 | 6.375 | % | $ 500 | $411 | $419 |
| Series B | 4/29/2014 | 9/15/2024 | 6.375 | % (1) | 500 | 457 | 465 |
| | | | | | $ 1,000 | $868 | $884 |

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(1) Dividends, if declared, will be paid quarterly at an annual rate equal to (i) for each period beginning prior to September 15, 2024, 6.375%, and (ii) for each period beginning on or after September 15, 2024, three-month LIBOR plus 3.536%.

For each preferred stock issuance listed above, Regions issued depositary shares, each representing a 1/40th ownership interest in a share of the Company's preferred stock, with a liquidation preference of $1,000.00 per share of preferred stock (equivalent to $25.00 per depositary share). Dividends on the preferred stock, if declared, accrue and are payable quarterly in arrears. The preferred stock has no stated maturity and redemption is solely at Regions' option, subject to regulatory approval, in whole, or in part, after the earliest redemption date or in whole, but not in part, within 90 days following a regulatory capital treatment event for the Series A preferred stock or at any time following a regulatory capital treatment event for the Series B preferred stock.

The Board of Directors declared $8 million in cash dividends on Series A Preferred Stock during the first quarters of 2015 and 2014. Series B Preferred Stock dividends were $8 million for the first quarter of 2015. Because the Company was in a retained deficit position, preferred dividends were recorded as a reduction of preferred stock, including related surplus.

COMMON STOCK

During the first quarter of 2015, Regions received no objection from the Federal Reserve to its 2015 capital plan that was submitted as part of the Comprehensive Capital Analysis and Review ("CCAR") process. On April 23, 2015, Regions' Board of Directors approved an increase of its quarterly common stock dividend to $0.06 per share effective with the quarterly dividend to be paid in July 2015. The Board also authorized a new $875 million common stock repurchase plan, permitting repurchases from the beginning of the second quarter of 2015 through the end of the second quarter of 2016. The Company began purchasing shares in April 2015, and as of May 5, 2015, Regions had repurchased approximately 7 million shares of common stock at a total cost of approximately $68 million. These shares were immediately retired upon repurchase and therefore will not be included in treasury stock.

On April 24, 2014, Regions' Board of Directors authorized a $350 million common stock repurchase plan, permitting repurchases from the beginning of the second quarter of 2014 through the end of the first quarter of 2015. During the first quarter of 2015, Regions concluded the plan with the repurchase of approximately 11 million shares of common stock at a total cost of approximately $102 million. All common shares repurchased under this plan were immediately retired and therefore are not included in treasury stock.

The Board of Directors declared a $0.05 per share cash dividend on common stock for the first quarter of 2015, and a $0.03 per share cash dividend for the first quarter of 2014.

ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

Activity within the balances in accumulated other comprehensive income (loss) is shown in the following tables:

| | Three Months Ended March 31, 2015 | | | | |
|---|---|---|---|---|---|
| | Unrealized losses on securities | Unrealized gains (losses) on securities | Unrealized gains (losses) on derivative | Defined benefit pension plans | Accumulated other comprehensive |

| | transferred to held to maturity | available for sale | instruments designated as cash flow hedges | and other post employment benefits | income (loss), net of tax |
|---|---|---|---|---|---|
| | (In millions) | | | | |
| Beginning of period | $(55) | $175 | $33 | $(391) | $ (238) |
| Net change | 2 | 77 | 37 | 7 | 123 |
| End of period | $(53) | $252 | $70 | $(384) | $ (115) |

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| | Three Months Ended March 31, 2014 | | | | |
|---|---|---|---|---|---|
| | Unrealized losses on securities transferred to held to maturity | Unrealized gains (losses) on securities available for sale | Unrealized gains (losses) on derivative instruments designated as cash flow hedges | Defined benefit pension plans and other post employment benefits | Accumulated other comprehensive income (loss), net of tax |
| | (In millions) | | | | |
| Beginning of period | $(64) | $(22) | $15 | $(248) | $ (319) |
| Net change | 2 | 78 | 6 | 4 | 90 |
| End of period | $(62) | $56 | $21 | $(244) | $ (229) |

The following tables present amounts reclassified out of accumulated other comprehensive income (loss) for the three months ended March 31, 2015 and 2014:

| Details about Accumulated Other Comprehensive Income (Loss) Components | Three Months Ended March 31, 2015 Amount Reclassified from Accumulated Other Comprehensive Income (Loss)(1) | Three Months Ended March 31, 2014 Amount Reclassified from Accumulated Other Comprehensive Income (Loss)(1) | Affected Line Item in the Consolidated Statements of Income |
|---|---|---|---|
| | (In millions) | | |
| Unrealized losses on securities transferred to held to maturity: | | | |
| | $(3) | $(3) | Net interest income |
| | 1 | 1 | Tax (expense) or benefit |
| | $(2) | $(2) | Net of tax |
| Unrealized gains and (losses) on available-for-sale securities: | | | |
| | $5 | $2 | Securities gains, net |
| | (2) | (1) | Tax (expense) or benefit |
| | $3 | $1 | Net of tax |
| Gains and (losses) on cash flow hedges: | | | |
| Interest rate contracts | $33 | $28 | Net interest income |
| | (12) | (11) | Tax (expense) or benefit |
| | $21 | $17 | Net of tax |
| Amortization of defined benefit pension plans and other post employment benefits: | | | |
| Prior-service cost | $— | $— | (2) |

| | | | |
|---|---|---|---|
| Actuarial gains (losses) | (12) | (6) | (2) |
| | (12) | (6) | Total before tax |
| | 4 | 2 | Tax (expense) or benefit |
| | $(8) | $(4) | Net of tax |
| Total reclassifications for the period | $14 | $12 | Net of tax |

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(1) Amounts in parentheses indicate reductions to net income.
(2) These accumulated other comprehensive income (loss) components are included in the computation of net periodic pension cost and are included in salaries and employee benefits on the consolidated statements of income (see Note 10 for additional details).

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NOTE 8. EARNINGS (LOSS) PER COMMON SHARE

The following table sets forth the computation of basic earnings (loss) per common share and diluted earnings (loss) per common share:

| | Three Months Ended March 31 | |
|---|---|---|
| | 2015 | 2014 |
| | (In millions, except per share amounts) | |
| Numerator: | | |
| Income from continuing operations | $236 | $303 |
| Preferred stock dividends | (16) | (8) |
| Income from continuing operations available to common shareholders | 220 | 295 |
| Income (loss) from discontinued operations, net of tax | (2) | 12 |
| Net income available to common shareholders | $218 | $307 |
| Denominator: | | |
| Weighted-average common shares outstanding—basic | 1,346 | 1,378 |
| Potential common shares | 12 | 12 |
| Weighted-average common shares outstanding—diluted | 1,358 | 1,390 |
| Earnings per common share from continuing operations available to common shareholders[1]: | | |
| Basic | $0.16 | $0.21 |
| Diluted | 0.16 | 0.21 |
| Earnings (loss) per common share from discontinued operations[1]: | | |
| Basic | (0.00) | 0.01 |
| Diluted | (0.00) | 0.01 |
| Earnings per common share[1]: | | |
| Basic | 0.16 | 0.22 |
| Diluted | 0.16 | 0.22 |

(1) Certain per share amounts may not appear to reconcile due to rounding.

For earnings (loss) per common share from discontinued operations, basic and diluted weighted-average common shares outstanding are the same for the three months ended March 31, 2015 due to a net loss.

The effect from the assumed exercise of 28 million and 25 million stock options for the three months ended March 31, 2015 and 2014, respectively, was not included in the above computations of diluted earnings per common share because such amounts would have had an antidilutive effect on earnings per common share.

NOTE 9. SHARE-BASED PAYMENTS

Regions administers long-term incentive compensation plans that permit the granting of incentive awards in the form of stock options, restricted stock awards, performance awards and stock appreciation rights. While Regions has the ability to issue stock appreciation rights, none have been issued to date. The terms of all awards issued under these plans are determined by the Compensation Committee of the Board of Directors; however, no awards may be granted after the tenth anniversary from the date the plans were initially approved by shareholders. Incentive awards usually vest based on employee service, generally within three years from the date of the grant. The contractual lives of options granted under these plans are typically ten years from the date of the grant.

On May 13, 2010, the shareholders of the Company approved the Regions Financial Corporation 2010 Long-Term Incentive Plan ("2010 LTIP"), which permits the Company to grant to employees and directors various forms of incentive compensation. These forms of incentive compensation are similar to the types of compensation approved in prior plans. The 2010 LTIP authorizes 100 million common share equivalents available for grant, where grants of options count as one share equivalent and grants of full value awards (e.g., shares of restricted stock, restricted stock units and performance stock units) count as 2.25 share equivalents. Unless otherwise determined by the Compensation

Committee of the Board of Directors, grants of restricted stock, restricted stock units, and performance stock units accrue dividends, or their notional equivalent, as they are declared by the Board of Directors, and are paid upon vesting of the award. Upon adoption of the 2010 LTIP, Regions closed all prior long-term incentive plans to new grants, and, accordingly, prospective grants must be made under the 2010 LTIP or a successor plan. All existing grants under

prior long-term incentive plans were unaffected by adoption of the 2010 LTIP. The number of remaining share equivalents available for future issuance under the 2010 LTIP was approximately 41 million at March 31, 2015.
On April 23, 2015, the shareholders of the Company approved the Regions Financial Corporation 2015 Long Term Incentive Plan ("2015 LTIP"), which permits the Company to grant to employees and directors various forms of incentive compensation. These forms of incentive compensation are similar to the types of compensation approved in prior plans. The 2015 LTIP authorizes 60 million common share equivalents available for grant, where grants of options and grants of full value awards (e.g., shares of restricted stock, restricted stock units and performance stock units) count as one share equivalent. Unless otherwise determined by the Compensation Committee of the Board of Directors, grants of restricted stock, restricted stock units, and performance stock units accrue dividends, or their notional equivalent, as they are declared by the Board of Directors, and are paid upon vesting of the award. Upon adoption of the 2015 LTIP, Regions closed the prior long-term incentive plan to new grants, and, accordingly, prospective grants must be made under the 2015 LTIP or a successor plan. All existing grants under prior long-term incentive plans are unaffected by adoption of the 2015 LTIP.

STOCK OPTIONS

The following table summarizes the activity related to stock options:

| | Three Months Ended March 31 | | | |
|---|---|---|---|---|
| | 2015 | | 2014 | |
| | Number of Options | Weighted-Average Exercise Price | Number of Options | Weighted-Average Exercise Price |
| Outstanding at beginning of period | 25,316,676 | $ 23.07 | 32,127,235 | $22.81 |
| Granted | — | — | — | — |
| Exercised | (42,056) | 7.00 | (1,330,599) | 4.29 |
| Canceled/Forfeited | (4,867,902) | 33.77 | (4,070,485) | 30.53 |
| Outstanding at end of period | 20,406,718 | $ 20.98 | 26,726,151 | $22.55 |
| Exercisable at end of period | 20,406,718 | $ 20.98 | 26,293,952 | $22.82 |

RESTRICTED STOCK AWARDS AND PERFORMANCE STOCK AWARDS

Regions periodically grants restricted stock awards that vest upon service conditions. Regions also periodically grants restricted stock awards and performance stock awards that vest based upon service conditions and performance conditions. Incremental shares earned above the performance target associated with previous performance stock awards are included when and if performance targets are achieved. Dividend payments during the vesting period are deferred to the end of the vesting term. The fair value of these restricted shares, restricted stock units and performance stock units was estimated based upon the fair value of the underlying shares on the date of the grant. The valuation was not adjusted for the deferral of dividends.

The following table summarizes the activity related to restricted stock awards and performance stock awards:

| | Three Months Ended March 31 | | | |
|---|---|---|---|---|
| | 2015 | | 2014 | |
| | Number of Shares | Weighted-Average Grant Date Fair Value | Number of Shares | Weighted-Average Grant Date Fair Value |
| Non-vested at beginning of period | 18,427,409 | $ 8.07 | 16,212,198 | $ 6.83 |
| Granted | 454,147 | 5.88 | 21,233 | 9.89 |
| Vested | (591,101) | 6.15 | (494,932) | 7.28 |
| Forfeited | (152,044) | 8.06 | (59,149) | 7.00 |
| Non-vested at end of period | 18,138,411 | $ 8.13 | 15,679,350 | $ 6.82 |

NOTE 10. PENSION AND OTHER POSTRETIREMENT BENEFITS

Regions has a defined benefit pension plan qualified under the Internal Revenue Code covering only certain employees as the pension plan is closed to new entrants. The Company also sponsors a supplemental executive retirement program (the "SERP"), which is a non-qualified pension plan that provides certain senior executive officers defined benefits in relation to their compensation.

Net periodic pension cost, which is recorded in salaries and employee benefits on the consolidated statements of income, included the following components:

| | Qualified Plan | | Non-qualified Plans | | Total | |
|---|---|---|---|---|---|---|
| | Three Months Ended March 31 | | | | | |
| | 2015 | 2014 | 2015 | 2014 | 2015 | 2014 |
| | (In millions) | | | | | |
| Service cost | $10 | $8 | $1 | $1 | $11 | $9 |
| Interest cost | 21 | 22 | 1 | 1 | 22 | 23 |
| Expected return on plan assets | (36) | (34) | — | — | (36) | (34) |
| Amortization of actuarial loss | 11 | 5 | 1 | 1 | 12 | 6 |
| Amortization of prior service cost | — | — | — | — | — | — |
| Net periodic pension cost | $6 | $1 | $3 | $3 | $9 | $4 |

Regions' policy for funding the qualified pension plan is to contribute annually at least the amount required by Internal Revenue Service minimum funding standards. Regions made a contribution of $150 million for the 2014 plan year during the first three months of 2015.

Regions also provides other postretirement benefits such as defined benefit health care plans and life insurance plans that cover certain retired employees. There was no material impact from other postretirement benefits on the consolidated financial statements for the three months ended March 31, 2015 or 2014.

NOTE 11. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

The following tables present the notional amount and estimated fair value of derivative instruments on a gross basis as of March 31, 2015 and December 31, 2014.

| | March 31, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|---|
| | Notional | Estimated Fair Value | | Notional | Estimated Fair Value | |
| | Amount | Gain(1) | Loss(1) | Amount | Gain(1) | Loss(1) |
| | (In millions) | | | | | |
| Derivatives in fair value hedging relationships: | | | | | | |
| Interest rate swaps | $2,410 | $13 | $47 | $2,817 | $6 | $30 |
| Derivatives in cash flow hedging relationships: | | | | | | |
| Interest rate swaps | 8,950 | 84 | 6 | 8,050 | 38 | 31 |
| Total derivatives designated as hedging instruments | $11,360 | $97 | $53 | $10,867 | $44 | $61 |
| Derivatives not designated as hedging instruments: | | | | | | |
| Interest rate swaps | $45,892 | $948 | $971 | $45,860 | $941 | $972 |
| Interest rate options | 2,824 | 15 | 1 | 3,016 | 10 | 2 |
| Interest rate futures and forward commitments | 16,010 | 8 | 8 | 17,978 | 3 | 8 |
| Other contracts | 4,203 | 213 | 206 | 4,149 | 217 | 211 |
| Total derivatives not designated as hedging instruments | $68,929 | $1,184 | $1,186 | $71,003 | $1,171 | $1,193 |
| Total derivatives | $80,289 | $1,281 | $1,239 | $81,870 | $1,215 | $1,254 |

(1) Derivatives in a gain position are recorded as other assets and derivatives in a loss position are recorded as other liabilities on the consolidated balance sheets.

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HEDGING DERIVATIVES

Derivatives entered into to manage interest rate risk and facilitate asset/liability management strategies are designated as hedging derivatives. Derivative financial instruments that qualify in a hedging relationship are classified, based on the exposure being hedged, as either fair value hedges or cash flow hedges. See Note 1 "Summary of Significant Accounting Policies" of the Annual Report on Form 10-K for the year ended December 31, 2014 for additional information regarding accounting policies for derivatives.

FAIR VALUE HEDGES

Fair value hedge relationships mitigate exposure to the change in fair value of an asset, liability or firm commitment. Regions enters into interest rate swap agreements to manage interest rate exposure on the Company’s fixed-rate borrowings, which includes long-term debt and certificates of deposit. These agreements involve the receipt of fixed-rate amounts in exchange for floating-rate interest payments over the life of the agreements. Regions enters into interest rate swap agreements to manage interest rate exposure on certain of the Company's fixed-rate available for sale securities. These agreements involve the payment of fixed-rate amounts in exchange for floating-rate interest receipts.

CASH FLOW HEDGES

Cash flow hedge relationships mitigate exposure to the variability of future cash flows or other forecasted transactions.

Regions enters into interest rate swap agreements to manage overall cash flow changes related to interest rate risk exposure on LIBOR-based loans. The agreements effectively modify the Company’s exposure to interest rate risk by utilizing receive fixed/pay LIBOR interest rate swaps.

Regions issues long-term fixed-rate debt for various funding needs. Regions may enter into receive LIBOR/pay fixed forward starting swaps to hedge risks of changes in the projected quarterly interest payments attributable to changes in the benchmark interest rate ("LIBOR") during the time leading up to the probable issuance date of the new long-term fixed-rate debt.

Regions recognized an unrealized after-tax gain of $25 million and $56 million in accumulated other comprehensive income (loss) at March 31, 2015 and 2014, respectively, related to terminated cash flow hedges of loan and debt instruments, which will be amortized into earnings in conjunction with the recognition of interest payments through 2017. Regions recognized pre-tax income of $11 million during both of the three months ended March 31, 2015 and 2014 related to the amortization of cash flow hedges of loan and debt instruments.

Regions expects to reclassify out of accumulated other comprehensive income (loss) and into earnings approximately $111 million in pre-tax income due to the receipt or payment of interest payments on all cash flow hedges within the next twelve months. Included in this amount is $35 million in pre-tax net gains related to the amortization of discontinued cash flow hedges. The maximum length of time over which Regions is hedging its exposure to the variability in future cash flows for forecasted transactions is approximately six years as of March 31, 2015.

The following tables present the effect of hedging derivative instruments on the consolidated statements of income:

| | Gain or (Loss) Recognized in Income on Derivatives | | Location of Amounts Recognized in Income on Derivatives and Related Hedged Item | Gain or (Loss) Recognized in Income on Related Hedged Item | |
|---|---|---|---|---|---|
| | Three Months Ended March 31 | | | Three Months Ended March 31 | |
| | 2015 | 2014 | | 2015 | 2014 |
| | (In millions) | | | (In millions) | |
| Fair Value Hedges: | | | | | |
| Interest rate swaps on: | | | | | |
| Debt/CDs | $4 | $9 | Interest expense | $4 | $2 |
| Debt/CDs | 7 | (8) | Other non-interest expense | (7) | 9 |
| Securities available for sale | (4) | (4) | Interest income | — | — |
| Securities available for sale | (20) | (18) | Other non-interest expense | 19 | 14 |
| Total | $(13) | $(21) | | $16 | $25 |

| | Effective Portion[3] Gain or (Loss) Recognized in AOCI[1] | | Location of Amounts Reclassified from AOCI into Income | Gain or (Loss) Reclassified from AOCI into Income[2] | |
|---|---|---|---|---|---|
| | Three Months Ended March 31 | | | Three Months Ended March 31 | |
| | 2015 | 2014 | | 2015 | 2014 |
| | (In millions) | | | (In millions) | |
| Cash Flow Hedges: | | | | | |
| Interest rate swaps | $37 | $4 | Interest income on loans | $33 | $31 |
| Forward starting swaps | — | 2 | Interest expense on debt | — | (3) |
| Total | $37 | $6 | | $33 | $28 |

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(1) After-tax
(2) Pre-tax
(3) All cash flow hedges were highly effective for all periods presented, and the change in fair value attributed to hedge ineffectiveness was not material.

DERIVATIVES NOT DESIGNATED AS HEDGING INSTRUMENTS

The Company maintains a derivatives portfolio of interest rate swaps, option contracts, and futures and forward commitments used to meet the needs of its customers. The portfolio is primarily used to help clients manage market risk. The Company is subject to the credit risk that a counterparty will fail to perform. The Company is also subject to market risk, which is evaluated by the Company and monitored by the asset/liability management process. Separate derivative contracts are entered into to reduce overall market exposure to pre-defined limits. The contracts in this portfolio do not qualify for hedge accounting and are marked-to-market through earnings and included in other assets and other liabilities.

Regions enters into interest rate lock commitments, which are commitments to originate mortgage loans whereby the interest rate on the loan is determined prior to funding and the customers have locked into that interest rate. At March 31, 2015 and December 31, 2014, Regions had $363 million and $233 million, respectively, in total notional amount of interest rate lock commitments. Regions manages market risk on interest rate lock commitments and

mortgage loans held for sale with corresponding forward sale commitments, which are recorded at fair value with changes in fair value recorded in mortgage income. At March 31, 2015 and December 31, 2014, Regions had $678 million and $621 million, respectively, in total notional amount related to these forward sale commitments.
Regions has elected to account for residential mortgage servicing rights at fair market value with any changes to fair value being recorded within mortgage income. Concurrent with the election to use the fair value measurement method, Regions began using various derivative instruments, in the form of forward rate commitments, futures contracts, swaps and swaptions to mitigate the consolidated statement of income effect of changes in the fair value of its residential mortgage servicing rights. As of March 31, 2015 and December 31, 2014, the total notional amount related to these contracts was $3.5 billion and $3.7 billion, respectively.
The following table presents the location and amount of gain or (loss) recognized in income on derivatives not designated as hedging instruments in the consolidated statements of income for the three months ended March 31, 2015 and 2014:

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| Derivatives Not Designated as Hedging Instruments | Three Months Ended March 31 2015 | 2014 |
|---|---|---|
| | (In millions) | |
| Capital markets fee income and other[1]: | | |
| Interest rate swaps | $4 | $2 |
| Interest rate options | — | — |
| Interest rate futures and forward commitments | (1) | — |
| Other contracts | 4 | 2 |
| Total capital markets fee income and other | 7 | 4 |
| Mortgage income: | | |
| Interest rate swaps | 13 | 8 |
| Interest rate options | 7 | 3 |
| Interest rate futures and forward commitments | 4 | (4) |
| Total mortgage income | 24 | 7 |
| | $31 | $11 |

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(1) Capital markets fee income and other is included in Other income on the consolidated statements of income.

Credit risk, defined as all positive exposures not collateralized with cash or other assets or reserved for, at March 31, 2015 and December 31, 2014, totaled approximately $486 million and $392 million, respectively. This amount represents the net credit risk on all trading and other derivative positions held by Regions.

CREDIT DERIVATIVES

Regions has both bought and sold credit protection in the form of participations on interest rate swaps (swap participations). These swap participations, which meet the definition of credit derivatives, were entered into in the ordinary course of business to serve the credit needs of customers. Credit derivatives, whereby Regions has purchased credit protection, entitle Regions to receive a payment from the counterparty when the customer fails to make payment on any amounts due to Regions upon early termination of the swap transaction and have maturities between 2015 and 2020. Credit derivatives whereby Regions has sold credit protection have maturities between 2016 and 2021. For contracts where Regions sold credit protection, Regions would be required to make payment to the counterparty when the customer fails to make payment on any amounts due to the counterparty upon early termination of the swap transaction. Regions bases the current status of the prepayment/performance risk on bought and sold credit derivatives on recently issued internal risk ratings consistent with the risk management practices of unfunded commitments.

Regions' maximum potential amount of future payments under these contracts as of March 31, 2015 was approximately $65 million. This scenario would only occur if variable interest rates were at zero percent and all counterparties defaulted with zero recovery. The fair value of sold protection at March 31, 2015 and 2014 was immaterial. In transactions where Regions has sold credit protection, recourse to collateral associated with the original swap transaction is available to offset some or all of Regions' obligation.

CONTINGENT FEATURES

Certain of Regions' derivative instrument contracts with broker-dealers contain credit-related termination provisions and/or credit-related provisions regarding the posting of collateral, allowing those broker-dealers to terminate the contracts in the event that Regions' and/or Regions Bank's credit ratings falls below specified ratings from certain major credit rating agencies. The aggregate fair value of all derivative instruments with any credit-risk-related contingent features that were in a liability position on March 31, 2015 and December 31, 2014, was $262 million and $272 million, respectively, for which Regions had posted collateral of $262 million and $272 million, respectively, in the normal course of business.

OFFSETTING

Regions engages in derivatives transactions with dealers and customers. These derivatives transactions are subject to enforceable master netting agreements, which include a right of setoff by the non-defaulting or non-affected party upon early termination of the derivatives transaction. The following table presents the Company's gross derivative positions, including collateral posted or received, as of March 31, 2015 and December 31, 2014.

| | Offsetting Derivative Assets | | Offsetting Derivative Liabilities | |
|---|---|---|---|---|
| | March 31, 2015 | December 31, 2014 | March 31, 2015 | December 31, 2014 |
| | (In millions) | | | |
| Gross amounts subject to offsetting | $1,180 | $1,157 | $1,143 | $1,195 |
| Gross amounts not subject to offsetting | 101 | 58 | 96 | 59 |
| Gross amounts recognized | 1,281 | 1,215 | 1,239 | 1,254 |
| Gross amounts offset in the consolidated balance sheets(1) | 787 | 815 | 1,000 | 1,054 |
| Net amounts presented in the consolidated balance sheets | 494 | 400 | 239 | 200 |
| Gross amounts not offset in the consolidated balance sheets: | | | | |
| Financial instruments | 8 | 8 | 28 | — |
| Cash collateral received/posted | — | — | 23 | 29 |
| Net amounts | $486 | $392 | $188 | $171 |

(1) At March 31, 2015, gross amounts of derivative assets and liabilities offset in the consolidated balance sheets presented above include cash collateral received of $118 million and cash collateral posted of $330 million. At December 31, 2014, gross amounts of derivative assets and liabilities offset in the consolidated balance sheets presented above include cash collateral received of $111 million and cash collateral posted of $354 million.

Gross amounts of derivatives not subject to offsetting primarily consist of derivatives cleared through a Central Counterparty Clearing House ("CCP") and interest rate lock commitments to originate mortgage loans. During 2014, Regions obtained legal opinions which support that trades cleared through the Chicago Mercantile Exchange are governed under a master netting agreement and, consequently, trades cleared through this CCP receive balance sheet netting treatment. Legal opinions have not been obtained for trades cleared through the London Clearing House, Ltd,. and, therefore, trades cleared through this CCP are not offset on Regions' consolidated balance sheets.

NOTE 12. FAIR VALUE MEASUREMENTS

See Note 1 “Summary of Significant Accounting Policies” to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2014 for a description of valuation methodologies for assets and liabilities measured at fair value on a recurring and non-recurring basis. Regions rarely transfers assets and liabilities measured at fair value between Level 1 and Level 2 measurements. There were no such transfers during the three month periods ended March 31, 2015 and 2014. Trading account securities and securities available for sale may be periodically transferred to or from Level 3 valuation based on management’s conclusion regarding the best method of pricing for an individual security. Such transfers are accounted for as if they occur at the beginning of a reporting period.

The following table presents assets and liabilities measured at estimated fair value on a recurring basis and non-recurring basis as of March 31, 2015 and December 31, 2014:

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| | March 31, 2015 | | | | December 31, 2014 | | | |
|---|---|---|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total Estimated Fair Value | Level 1 | Level 2 | Level 3 | Total Estimated Fair Value |
| | (In millions) | | | | | | | |
| Recurring fair value measurements | | | | | | | | |
| Trading account securities | $107 | $— | $— | $ 107 | $106 | $— | $— | $ 106 |
| Securities available for sale: | | | | | | | | |
| U.S. Treasury securities | $180 | $— | $— | $ 180 | $176 | $— | $— | $ 176 |
| Federal agency securities | — | 234 | — | 234 | — | 235 | — | 235 |
| Obligations of states and political subdivisions | — | 2 | — | 2 | — | 2 | — | 2 |
| Mortgage-backed securities (MBS): | | | | | | | | |
| Residential agency | — | 16,153 | — | 16,153 | — | 16,038 | — | 16,038 |
| Residential non-agency | — | — | 7 | 7 | — | — | 8 | 8 |
| Commercial agency | — | 1,990 | — | 1,990 | — | 1,964 | — | 1,964 |
| Commercial non-agency | — | 1,556 | — | 1,556 | — | 1,494 | — | 1,494 |
| Corporate and other debt securities | — | 2,071 | 3 | 2,074 | — | 1,987 | 3 | 1,990 |
| Equity securities[1] | 179 | — | — | 179 | 146 | — | — | 146 |
| Total securities available for sale | $359 | $22,006 | $10 | $ 22,375 | $322 | $21,720 | $11 | $ 22,053 |
| Mortgage loans held for sale | $— | $396 | $— | $ 396 | $— | $440 | $— | $ 440 |
| Residential mortgage servicing rights | $— | $— | $239 | $ 239 | $— | $— | $257 | $ 257 |
| Derivative assets: | | | | | | | | |
| Interest rate swaps | $— | $1,045 | $— | $ 1,045 | $— | $985 | $— | $ 985 |
| Interest rate options | — | 1 | 14 | 15 | — | 2 | 8 | 10 |
| Interest rate futures and forward commitments | — | 8 | — | 8 | — | 3 | — | 3 |
| Other contracts | — | 213 | — | 213 | — | 217 | — | 217 |
| Total derivative assets | $— | $1,267 | $14 | $ 1,281 | $— | $1,207 | $8 | $ 1,215 |
| Derivative liabilities: | | | | | | | | |
| Interest rate swaps | $— | $1,024 | $— | $ 1,024 | $— | $1,033 | $— | $ 1,033 |
| Interest rate options | — | 1 | — | 1 | — | 2 | — | 2 |
| Interest rate futures and forward commitments | — | 8 | — | 8 | — | 8 | — | 8 |
| Other contracts | — | 206 | — | 206 | — | 211 | — | 211 |
| Total derivative liabilities | $— | $1,239 | $— | $ 1,239 | $— | $1,254 | $— | $ 1,254 |
| Nonrecurring fair value measurements | | | | | | | | |
| Loans held for sale | $— | $— | $14 | $ 14 | $— | $— | $33 | $ 33 |
| Foreclosed property and other real estate | — | 35 | 33 | 68 | — | 41 | 8 | 49 |

(1) Excludes Federal Reserve Bank and Federal Home Loan Bank Stock totaling $488 million and $16 million at March 31, 2015 and $488 million and $39 million at December 31, 2014, respectively.

Assets and liabilities in all levels could result in volatile and material price fluctuations. Realized and unrealized gains and losses on Level 3 assets represent only a portion of the risk to market fluctuations in Regions' consolidated balance sheets. Further, derivatives included in Levels 2 and 3 are used by the Asset and Liability Management Committee of the Company in a holistic approach to managing price fluctuation risks.

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The following tables illustrate a rollforward for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2015 and 2014. The tables do not reflect the change in fair value attributable to any related economic hedges the Company used to mitigate the interest rate risk associated with these assets and liabilities. The net changes in realized gains (losses) included in earnings related to Level 3 assets and liabilities held at March 31, 2015 and 2014 are not material.

Three Months Ended March 31, 2015

| | | Total Realized / Unrealized Gains or Losses | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Opening Balance January 1, 2015 | Included in Earnings | Included in Other Compre-hensive Income (Loss) | Purchases | Sales | Issuances | Settlements | Transfers into Level 3 | Transfers out of Level 3 | Closing Balance March 31, 2015 |
| | (In millions) | | | | | | | | | |
| Level 3 Instruments Only | | | | | | | | | | |
| Securities available for sale: | | | | | | | | | | |
| Residential non-agency MBS | $8 | — | — | — | — | — | (1) | — | — | $7 |
| Corporate and other debt securities | 3 | — | — | — | — | — | — | — | — | 3 |
| Total securities available for sale | $11 | — | — | — | — | — | (1) | — | — | $10 |
| Residential mortgage servicing rights | $257 | (25) [(1)] | — | 7 | — | — | — | — | — | $239 |
| Total interest rate options derivatives, net | $8 | 28 [(1)] | — | — | — | — | (22) | — | — | $14 |

Three Months Ended March 31, 2014

| | | Total Realized / Unrealized Gains or Losses | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Opening Balance January 1, 2014 | Included in Earnings | Included in Other Compre-hensive Income (Loss) | Purchases | Sales | Issuances | Settlements | Transfers into Level 3 | Transfers out of Level 3 | Closing Balance March 31, 2014 |
| | (In millions) | | | | | | | | | |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Level 3 Instruments Only | | | | | | | | | | |
| Securities available for sale: | | | | | | | | | | |
| Residential non-agency MBS | $9 | — | — | — | — | — | — | — | — | $9 |
| Corporate and other debt securities | 2 | — | — | 3 | — | — | (2) | — | — | 3 |
| Total securities available for sale | $11 | — | — | 3 | — | — | (2) | — | — | $12 |
| Residential mortgage servicing rights | $297 | (17) [1] | — | 8 | — | — | — | — | — | $288 |
| Total interest rate options derivatives, net | $5 | 21 [1] | — | — | — | — | (18) | — | — | $8 |

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(1) Included in mortgage income.

The following table presents the fair value adjustments related to non-recurring fair value measurements:

| | Three Months Ended March 31 | |
|---|---|---|
| | 2015 | 2014 |
| | (In millions) | |
| Loans held for sale | $(7) | $(15) |
| Foreclosed property and other real estate | (7) | (7) |

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The following tables present detailed information regarding assets and liabilities measured at fair value using significant unobservable inputs (Level 3) as of March 31, 2015 and December 31, 2014. The tables include the valuation techniques and the significant unobservable inputs utilized. The range of each significant unobservable input as well as the weighted average within the range utilized at March 31, 2015 and December 31, 2014 are included. Following the tables are a description of the valuation technique and the sensitivity of the technique to changes in the significant unobservable input.

| | March 31, 2015<br>Level 3<br>Estimated Fair Value at March 31, 2015<br>(Dollars in millions) | Valuation Technique | Unobservable Input(s) | Quantitative Range of Unobservable Inputs and (Weighted-Average) |
|---|---|---|---|---|
| Recurring fair value measurements: | | | | |
| Securities available for sale: | | | | |
| Residential non-agency MBS | $7 | Discounted cash flow | Spread to LIBOR | 5.3% - 49.8% (14.6%) |
| | | | Weighted-average prepayment speed (CPR; percentage) | 5.5% - 14.2% (9.4%) |
| | | | Probability of default | 1.4% |
| | | | Loss severity | 40.2% |
| Corporate and other debt securities | $3 | Market comparable | Evaluated quote on same issuer/comparable bond | 99.9% |
| Residential mortgage servicing rights[(1)] | $239 | Discounted cash flow | Weighted-average prepayment speed (CPR; percentage) | 11.9% - 14.0% (12.7%) |
| | | | Option-adjusted spread (percentage) | 8.7% - 17.4% (10.1%) |
| Derivative assets: | | | | |
| Interest rate options | $14 | Discounted cash flow | Weighted-average prepayment speed (CPR; percentage) | 11.9% - 14.0% (12.7%) |
| | | | Option-adjusted spread (percentage) | 8.7% - 17.4% (10.1%) |
| | | | Pull-through | 20.3% - 99.1% (86.9%) |
| Nonrecurring fair value measurements: | | | | |
| Loans held for sale | $14 | Commercial loans held for sale are valued based on multiple data points, including discount to appraised value of collateral based on recent market activity | Appraisal comparability adjustment (discount) | 27.3% - 99.9% (63.7%) |

| | | | | |
|---|---|---|---|---|
| | | for sales of similar loans | | |
| Foreclosed property and other real estate | $33 | Discount to appraised value of property based on recent market activity for sales of similar properties | Appraisal comparability adjustment (discount) | 25.0% - 61.7% (28.2%) |

(1) See Note 5 for additional disclosures related to assumptions used in the fair value calculation for residential mortgage servicing rights.

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| | December 31, 2014 Level 3 Estimated Fair Value at December 31, 2014 (Dollars in millions) | Valuation Technique | Unobservable Input(s) | Quantitative Range of Unobservable Inputs and (Weighted-Average) |
|---|---|---|---|---|
| Recurring fair value measurements: | | | | |
| Securities available for sale: | | | | |
| Residential non-agency MBS | $8 | Discounted cash flow | Spread to LIBOR | 5.4% - 49.9% (12.3%) |
| | | | Weighted-average prepayment speed (CPR; percentage) | 6.3% - 15.0% (9.5%) |
| | | | Probability of default | 1.4% |
| | | | Loss severity | 37.4% |
| Corporate and other debt securities | $3 | Market comparable | Evaluated quote on same issuer/comparable bond | 99.9% |
| Residential mortgage servicing rights(1) | $257 | Discounted cash flow | Weighted-average prepayment speed (CPR; percentage) | 9.9% - 22.4% (12.0%) |
| | | | Option-adjusted spread (percentage) | 7.7% - 11.3% (9.0%) |
| Derivative assets: | | | | |
| Interest rate options | $8 | Discounted cash flow | Weighted-average prepayment speed (CPR; percentage) | 9.9% - 22.4% (12.0%) |
| | | | Option-adjusted spread (percentage) | 7.7% - 11.3% (9.0%) |
| | | | Pull-through | 7.3% - 99.1% (87.8%) |
| Nonrecurring fair value measurements: | | | | |
| Loans held for sale | $33 | Commercial loans held for sale are valued based on multiple data points, including discount to appraised value of collateral based on recent market activity for sales of similar loans | Appraisal comparability adjustment (discount) | 8.3% - 90.9% (53.3%) |
| Foreclosed property and other real estate | $8 | Discount to appraised value of property based on recent market activity | Appraisal comparability adjustment (discount) | 3.7% - 73.0% (29.6%) |

for sales of similar
properties

(1) See Note 7 to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2014 for additional disclosures related to assumptions used in the fair value calculation for residential mortgage servicing rights.

RECURRING FAIR VALUE MEASUREMENTS USING SIGNIFICANT UNOBSERVABLE INPUTS

Securities available for sale

Mortgage-backed securities: residential non-agency—The fair value reported in this category relates to retained interests in legacy securitizations. Significant unobservable inputs include the spread to LIBOR, constant prepayment rate, probability of default, and loss severity in the event of default. Significant increases in any of these inputs in isolation would result in significantly lower fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for loss severity and a directionally opposite change in the assumption used for prepayment rates.

Corporate and other debt securities—Significant unobservable inputs include evaluated quotes on comparable bonds for the same issuer and management-determined comparability adjustments. Changes in the evaluated quote on comparable bonds would result in a directionally similar change in the fair value of the other debt securities.

Residential mortgage servicing rights
The significant unobservable inputs used in the fair value measurement of residential mortgage servicing rights ("MSR") are option adjusted spreads ("OAS") and prepayment speed. This method requires generating cash flow projections over multiple interest rate scenarios and discounting those cash flows at a risk adjusted rate. Additionally, the impact of prepayments and changes in the OAS are based on a variety of underlying inputs such as servicing costs. Increases or decreases to the underlying cash flow inputs will have a corresponding impact on the value of the MSR asset. The net change in unrealized gains (losses) included in earnings related to MSRs held at period end are disclosed as the changes in valuation inputs or assumptions included in the MSR rollforward table in Note 5. See Note 5 for these amounts and additional disclosures related to assumptions used in the fair value calculation for MSRs.
Derivative assets
Interest rate options—These instruments are interest rate lock agreements made in the normal course of originating residential mortgage loans. Significant unobservable inputs in the fair value measurement are OAS, prepayment speeds, and pull-through. The impact of OAS and prepayment speed inputs in the valuation of these derivative instruments are consistent with the MSR discussion above. Pull-through is an estimate of the number of interest rate lock commitments that will ultimately become funded loans. Increases or decreases in the pull-through assumption will have a corresponding impact on the value of these derivative assets.
NON-RECURRING FAIR VALUE MEASUREMENTS USING SIGNIFICANT UNOBSERVABLE INPUTS
Loans held for sale
Commercial loans held for sale are valued based on multiple data points indicating the fair value for each loan. The primary data point for loans held for sale is a discount to the appraised value of the underlying collateral, which considers the return required by potential buyers of the loans. Management establishes this discount or comparability adjustment based on recent sales of loans secured by similar property types. As liquidity in the market increases or decreases, the comparability adjustment and the resulting asset valuation are impacted.
Foreclosed property and other real estate
Foreclosed property and other real estate are valued based on offered quotes as available. If no sales contract is pending for a specific property, management establishes a comparability adjustment to the appraised value based on historical activity considering proceeds for properties sold versus the corresponding appraised value. Increases or decreases in realization for properties sold impact the comparability adjustment for similar assets remaining on the balance sheet.
FAIR VALUE OPTION
Regions has elected the fair value option for all FNMA and FHLMC eligible residential mortgage loans originated with the intent to sell. These elections allow for a more effective offset of the changes in fair values of the loans and the derivative instruments used to economically hedge them without the burden of complying with the requirements for hedge accounting. Regions has not elected the fair value option for other loans held for sale primarily because they are not economically hedged using derivative instruments. Fair values of mortgage loans held for sale are based on traded market prices of similar assets where available and/or discounted cash flows at market interest rates, adjusted for securitization activities that include servicing values and market conditions, and are recorded in loans held for sale in the consolidated balance sheets.
The following table summarizes the difference between the aggregate fair value and the aggregate unpaid principal balance for mortgage loans held for sale measured at fair value:

| March 31, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|
| Aggregate Fair Value | Aggregate Unpaid Principal | Aggregate Fair Value Less Aggregate Unpaid Principal | Aggregate Fair Value | Aggregate Unpaid Principal | Aggregate Fair Value Less Aggregate Unpaid Principal |
| (In millions) | | | | | |
| $396 | $381 | $ 15 | $440 | $421 | $ 19 |

Mortgage loans held for sale, at
fair value

Interest income on mortgage loans held for sale is recognized based on contractual rates and is reflected in interest income on loans held for sale in the consolidated statements of income. The following table details net gains resulting from changes in fair value of these loans which were recorded in mortgage income in the consolidated statements of income during the three months ended March 31, 2015 and 2014, respectively. These changes in fair value are mostly offset by economic hedging activities. An immaterial portion of these amounts was attributable to changes in instrument-specific credit risk.

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| | Mortgage loans held for sale, at fair value | |
|---|---|---|
| | Three Months Ended March 31 | |
| | 2015 | 2014 |
| | (In millions) | |
| Net gains (losses) resulting from changes in fair value | $ (4 ) | $ 6 |

The carrying amounts and estimated fair values, as well as the level within the fair value hierarchy, of the Company's financial instruments as of March 31, 2015 are as follows:

| | March 31, 2015 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value(1) | Level 1 | Level 2 | Level 3 |
| | (In millions) | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $6,026 | $6,026 | $6,026 | $— | $— |
| Trading account securities | 107 | 107 | 107 | — | — |
| Securities held to maturity | 2,129 | 2,186 | 1 | 2,185 | — |
| Securities available for sale | 22,879 | 22,879 | 359 | 22,510 | 10 |
| Loans held for sale | 491 | 491 | — | 396 | 95 |
| Loans (excluding leases), net of unearned income and allowance for loan losses(2)(3) | 75,324 | 71,683 | — | — | 71,683 |
| Other interest-earning assets | 83 | 83 | — | 83 | — |
| Derivative assets | 1,281 | 1,281 | — | 1,267 | 14 |
| Financial liabilities: | | | | | |
| Derivative liabilities | 1,239 | 1,239 | — | 1,239 | — |
| Deposits | 97,477 | 97,469 | — | 97,469 | — |
| Short-term borrowings | 2,085 | 2,085 | — | 2,085 | — |
| Long-term borrowings | 3,208 | 3,860 | — | 2,869 | 991 |
| Loan commitments and letters of credit | 104 | 544 | — | — | 544 |
| Indemnification obligation | 204 | 188 | — | — | 188 |

(1) Estimated fair values are consistent with an exit price concept. The assumptions used to estimate the fair values are intended to approximate those that a market participant would use in a hypothetical orderly transaction. In estimating fair value, the Company makes adjustments for interest rates, market liquidity and credit spreads as appropriate.

(2) The estimated fair value of portfolio loans assumes sale of the loans to a third-party financial investor. Accordingly, the value to the Company if the loans were held to maturity is not reflected in the fair value estimate. In the current whole loan market, financial investors are generally requiring a higher rate of return than the return inherent in loans if held to maturity. The fair value discount at March 31, 2015 was $3.6 billion or 4.8 percent.

(3) Excluded from this table is the lease carrying amount of $1.8 billion at March 31, 2015.

The carrying amounts and estimated fair values, as well as the level within the fair value hierarchy, of the Company's financial instruments as of December 31, 2014 are as follows:

| | December 31, 2014 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value(1) | Level 1 | Level 2 | Level 3 |
| | (In millions) | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $4,004 | $4,004 | $4,004 | $— | $— |
| Trading account securities | 106 | 106 | 106 | — | — |
| Securities held to maturity | 2,175 | 2,209 | 1 | 2,208 | — |
| Securities available for sale | 22,580 | 22,580 | 322 | 22,247 | 11 |
| Loans held for sale | 541 | 541 | — | 440 | 101 |
| Loans (excluding leases), net of unearned income and allowance for loan losses(2)(3) | 74,482 | 70,114 | — | — | 70,114 |
| Other interest-earning assets | 89 | 89 | — | 89 | — |
| Derivative assets | 1,215 | 1,215 | — | 1,207 | 8 |
| Financial liabilities: | | | | | |
| Derivative liabilities | 1,254 | 1,254 | — | 1,254 | — |
| Deposits | 94,200 | 94,186 | — | 94,186 | — |
| Short-term borrowings | 2,253 | 2,253 | — | 2,253 | — |
| Long-term borrowings | 3,462 | 3,871 | — | 3,504 | 367 |
| Loan commitments and letters of credit | 106 | 539 | — | — | 539 |
| Indemnification obligation | 206 | 198 | — | — | 198 |

(1) Estimated fair values are consistent with an exit price concept. The assumptions used to estimate the fair values are intended to approximate those that a market participant would use in a hypothetical orderly transaction. In estimating fair value, the Company makes adjustments for interest rates, market liquidity and credit spreads as appropriate.

(2) The estimated fair value of portfolio loans assumes sale of the loans to a third-party financial investor. Accordingly, the value to the Company if the loans were held to maturity is not reflected in the fair value estimate. In the current whole loan market, financial investors are generally requiring a higher rate of return than the return inherent in loans if held to maturity. The fair value discount at December 31, 2014 was $4.4 billion or 5.9 percent.

(3) Excluded from this table is the lease carrying amount of $1.7 billion at December 31, 2014.

NOTE 13. BUSINESS SEGMENT INFORMATION

Each of Regions’ reportable segments is a strategic business unit that serves specific needs of Regions’ customers based on the products and services provided. The segments are based on the manner in which management views the financial performance of the business. The Company has three reportable segments: Corporate Bank, Consumer Bank, and Wealth Management, with the remainder split between Discontinued Operations and Other. During the fourth quarter of 2014, Regions reorganized its internal management structure and, accordingly, its segment reporting structure. Previously, Regions’ three operating segments were Business Services, Consumer Services, and Wealth Management. Under the organizational realignment, Regions has created a Consumer Bank, which consists principally of the previous Consumer Services segment with businesses that serve retail and small business banking customers, and a Corporate Bank, which consists principally of the previous Business Services segment with businesses that serve middle-market and large commercial clients. Previously, small business banking was located within Business Services, but now resides in the Consumer Bank as its product set is more consistent with those offered in that segment. The Wealth Management segment remained unchanged during the reorganization. Segment results for all periods presented have been recast to reflect this organizational realignment.

The application and development of management reporting methodologies is a dynamic process and is subject to periodic enhancements. As these enhancements are made, financial results presented by each reportable segment may be periodically revised.

The following tables present financial information for each reportable segment for the period indicated.

| | Three Months Ended March 31, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Corporate Bank | Consumer Bank | Wealth Management | Other | Continuing Operations | Discontinued Operations | Consolidated |
| | (In millions) | | | | | | |
| Net interest income (loss) | $280 | $601 | $42 | $(108) | $815 | $— | $815 |
| Provision (credit) for loan losses | — | 53 | 2 | (6) | 49 | — | 49 |
| Non-interest income | 90 | 265 | 99 | 16 | 470 | — | 470 |
| Non-interest expense | 153 | 589 | 105 | 58 | 905 | 4 | 909 |
| Income (loss) before income taxes | 217 | 224 | 34 | (144) | 331 | (4) | 327 |
| Income tax expense (benefit) | 82 | 85 | 13 | (85) | 95 | (2) | 93 |
| Net income (loss) | $135 | $139 | $21 | $(59) | $236 | $(2) | $234 |
| Average assets | $45,150 | $37,993 | $2,912 | $34,511 | $120,566 | $— | $120,566 |

| | Three Months Ended March 31, 2014 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Corporate Bank | Consumer Bank | Wealth Management | Other | Continuing Operations | Discontinued Operations | Consolidated |
| | (In millions) | | | | | | |
| Net interest income (loss) | $283 | $611 | $43 | $(121) | $816 | $— | $816 |
| Provision (credit) for loan losses | — | 81 | 1 | (80) | 2 | — | 2 |
| Non-interest income | 75 | 275 | 92 | 15 | 457 | — | 457 |
| Non-interest expense | 136 | 563 | 100 | 18 | 817 | (19) | 798 |
| Income (loss) before income taxes | 222 | 242 | 34 | (44) | 454 | 19 | 473 |
| Income tax expense (benefit) | 84 | 92 | 13 | (38) | 151 | 7 | 158 |
| Net income (loss) | $138 | $150 | $21 | $(6) | $303 | $12 | $315 |
| Average assets | $42,515 | $38,728 | $2,959 | $33,515 | $117,717 | $— | $117,717 |

NOTE 14. COMMITMENTS, CONTINGENCIES AND GUARANTEES

COMMERCIAL COMMITMENTS

Regions issues off-balance sheet financial instruments in connection with lending activities. The credit risk associated with these instruments is essentially the same as that involved in extending loans to customers and is subject to Regions' normal credit approval policies and procedures. Regions measures inherent risk associated with these instruments by recording a reserve for unfunded commitments based on an assessment of the likelihood that the guarantee will be funded and the creditworthiness of the customer or counterparty. Collateral is obtained based on management's assessment of the creditworthiness of the customer.

Credit risk associated with these instruments is represented by the contractual amounts indicated in the following table:

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (In millions) | |
| Unused commitments to extend credit | $44,642 | $43,724 |
| Standby letters of credit | 1,629 | 1,697 |
| Commercial letters of credit | 41 | 71 |
| Liabilities associated with standby letters of credit | 38 | 40 |
| Assets associated with standby letters of credit | 38 | 40 |
| Reserve for unfunded credit commitments | 66 | 65 |

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Unused commitments to extend credit—To accommodate the financial needs of its customers, Regions makes commitments under various terms to lend funds to consumers, businesses and other entities. These commitments include (among others) credit card and other revolving credit agreements, term loan commitments and short-term borrowing agreements. Many of these loan commitments have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of these commitments are expected to expire without being funded, the total commitment amounts do not necessarily represent future liquidity requirements.

Standby letters of credit—Standby letters of credit are also issued to customers which commit Regions to make payments on behalf of customers if certain specified future events occur. Regions has recourse against the customer for any amount required to be paid to a third party under a standby letter of credit. Historically, a large percentage of standby letters of credit expire without being funded. The contractual amount of standby letters of credit represents the maximum potential amount of future payments Regions could be required to make and represents Regions' maximum credit risk.

Commercial letters of credit—Commercial letters of credit are issued to facilitate foreign or domestic trade transactions for customers. As a general rule, drafts will be drawn when the goods underlying the transaction are in transit.

LEGAL CONTINGENCIES

Regions, its affiliates and subsidiaries, and current and former officers, directors and employees, are sometimes collectively referred to as Regions and certain Related Persons. Regions and its subsidiaries are subject to loss contingencies related to litigation, claims, investigations and legal and administrative cases and proceedings arising in the ordinary course of business. Regions evaluates these contingencies based on information currently available, including advice of counsel. Regions establishes accruals for those matters when a loss contingency is considered probable and the related amount is reasonably estimable. Any accruals are periodically reviewed and may be adjusted as circumstances change. Some of Regions' exposure with respect to loss contingencies may be offset by applicable insurance coverage. In determining the amounts of any accruals or estimates of possible loss contingencies however, Regions does not take into account the availability of insurance coverage. To the extent that Regions has an insurance recovery, the proceeds are recorded in the period the recovery is received.

In addition, as previously discussed, Regions has agreed to indemnify Raymond James for all legal matters resulting from pre-closing activities in conjunction with the sale of Morgan Keegan and recorded an indemnification obligation at fair value in the second quarter of 2012. The indemnification obligation had a carrying amount of approximately $204 million and an estimated fair value of approximately $188 million as of March 31, 2015 (see Note 12).

When it is practicable, Regions estimates possible loss contingencies, whether or not there is an accrued probable loss. When Regions is able to estimate such possible losses, and when it is reasonably possible Regions could incur losses in excess of amounts accrued, Regions is required to make a disclosure of the aggregate estimation. Regions currently estimates that it is reasonably possible that it may experience losses in excess of what Regions has accrued in an aggregate amount up to approximately $160 million as of March 31, 2015, with it also being reasonably possible that Regions could incur no losses in excess of amounts accrued. However, as available information changes, the matters for which Regions is able to estimate, as well as the estimates themselves will be adjusted accordingly. The reasonably possible estimate includes legal contingencies that are subject to the indemnification agreement with Raymond James.

Assessments of litigation and claims exposure are difficult because they involve inherently unpredictable factors including, but not limited to, the following: whether the proceeding is in the early stages; whether damages are unspecified, unsupported, or uncertain; whether there is a potential for punitive or other pecuniary damages; whether the matter involves legal uncertainties, including novel issues of law; whether the matter involves multiple parties and/or jurisdictions; whether discovery has begun or is not complete; whether meaningful settlement discussions have commenced; and whether the lawsuit involves class allegations. Assessments of class action litigation, which is generally more complex than other types of litigation, are particularly difficult, especially in the early stages of the proceeding when it is not known if a class will be certified or how a potential class, if certified, will be defined. As a result, Regions may be unable to estimate reasonably possible losses with respect to some of the matters disclosed below, and the aggregated estimated amount provided above may not include an estimate for every matter disclosed below.

Beginning in December 2007, Regions and certain of its affiliates were named in class-action lawsuits filed in federal and state courts on behalf of investors who purchased shares of certain Regions Morgan Keegan Select Funds (the “Funds”) and stockholders of Regions. These cases have been consolidated into class-actions and stockholder derivative actions for the open-end and closed-end Funds. The Funds were formerly managed by Regions Investment Management, Inc. (“Regions Investment Management”). Regions Investment Management no longer manages these Funds, which were transferred to Hyperion Brookfield Asset Management (“Hyperion”) in 2008. Certain of the Funds have since been terminated by Hyperion. The complaints contain various allegations, including claims that the Funds and the defendants misrepresented or failed to disclose material facts relating to the activities of the Funds. Plaintiffs have requested equitable relief and unspecified monetary damages. The U.S. District Court for the Western District of Tennessee has granted final approval of a settlement in the closed-end Funds class-action and shareholder derivative case as well as final approval of a settlement in a consolidated class action under the Employment Retirement Income Security Act. Approvals for settlements in the open-end Funds class action and shareholder derivative case and for investors represented by the Trustee Ad Litem are also being sought. Certain of the shareholders in these Funds and other interested parties have entered into arbitration proceedings and individual civil claims, in lieu of participating in the class actions. These lawsuits and proceedings are subject to the indemnification agreement with Raymond James discussed above.

In July 2006, Morgan Keegan and a former Morgan Keegan analyst were named as defendants in a lawsuit filed by a Canadian insurance and financial services company and its American subsidiary in the Circuit Court of Morris County, New Jersey. Plaintiffs alleged claims under a civil Racketeer Influenced and Corrupt Organizations (“RICO”) statute and claims for commercial disparagement, tortious interference with contractual relationships, tortious interference with prospective economic advantage and common law conspiracy. Plaintiffs allege that defendants engaged in a multi-year conspiracy to publish and disseminate false and defamatory information about plaintiffs to improperly drive down plaintiffs’ stock price, so that others could profit from short positions. Plaintiffs allege that defendants’ actions damaged their reputations and harmed their business relationships. Plaintiffs seek monetary damages for a number of categories of alleged damages, including lost insurance business, lost financings and increased financing costs, increased audit fees and directors and officers insurance premiums and lost acquisitions. In September 2012, the trial court dismissed the case with prejudice. Plaintiffs have filed an appeal. This matter is subject to the indemnification agreement with Raymond James.

The Securities and Exchange Commission ("SEC") and states of Missouri and Texas are investigating alleged securities law violations by Morgan Keegan in the underwriting and sale of certain municipal bonds. An enforcement action brought by the Missouri Secretary of State in April 2013, seeking monetary penalties and other relief, was dismissed and refiled in November 2013. A civil action was brought by institutional investors of the bonds in March 2012, seeking a return of their investment and unspecified compensatory and punitive damages. Trial of this case is currently set for November 2015 in the Circuit Court for Cole County, Missouri. A class action was brought on behalf of retail purchasers of the bonds in September 2012, seeking unspecified compensatory and punitive damages. In September 2014, the District Court for the Western District of Missouri granted class certification. The parties agreed to settlement terms in January 2015 and are awaiting final approval of the settlement by the Court. Other individual investors and investor groups have also filed arbitration claims or separate civil claims, which are pending in various stages. These matters are subject to the indemnification agreement with Raymond James.

In October 2010, a class-action lawsuit was filed by Regions’ stockholders in the U.S. District Court for the Northern District of Alabama (the “District Court”) against Regions and certain former officers of Regions (the "2010 Claim"). The 2010 Claim alleges violations of the federal securities laws, including allegations that materially false and misleading statements were included in filings made with the SEC. The plaintiffs have requested equitable relief and unspecified monetary damages. In June 2011, the District Court denied Regions’ motion to dismiss the 2010 Claim. In June 2012, District Court granted class certification. In September 2014, the Eleventh Circuit Court of Appeals vacated certification in part and remanded the 2010 Claim to District Court for further consideration of the class certification issue. Following recertification in the District Court, Regions filed a petition for permissive appeal in the Eleventh Circuit Court of Appeals concerning the class certification, which was denied, as was a request for reconsideration. Trial is set for November 2015.

Regions is involved in formal and informal information-gathering requests, investigations, reviews, examinations and proceedings by various governmental regulatory agencies, law enforcement authorities and self-regulatory bodies regarding Regions’ business, Regions' business practices and policies and the conduct of persons with whom Regions does business. Additional inquiries will arise from time to time. In connection with those inquiries, Regions receives document requests, subpoenas and other requests for information. The inquiries, including those described below, could develop into administrative, civil or criminal proceedings or enforcement actions that could result in consequences that have a material effect on Regions' consolidated financial position, results of operations or cash flows as a whole. Such consequences could include adverse judgments, findings, settlements, penalties, fines, orders, injunctions, restitution, or alterations in our business practices, and could result in additional expenses and collateral costs, including reputational damage.

In 2013, Regions received investigative requests from the Office of Inspector General of the Department of Housing and Urban Development regarding its residential mortgage loan origination, underwriting and quality control practices for Federal Housing Administration ("FHA") insured loans made by Regions. More recently, in September 2014, Regions received an investigative request from the Office of Inspector General of the Federal Housing Finance Agency ("FHFA") regarding its residential mortgage loan origination, underwriting and quality control practices for loans Regions sold to Fannie Mae and Freddie Mac. These inquiries are part of industry-wide investigations, and Regions is cooperating with the inquiries. Many institutions have settled these matters on terms that included large monetary penalties, including, in some cases, civil money penalties under applicable banking laws. The Company cannot predict the ultimate outcome of the investigations concerning its practices, however it is possible that these investigations could result in the payment of a monetary penalty which may adversely affect results of operations. While the final outcome of litigation and claims exposures or of any inquiries is inherently unpredictable, management is currently of the opinion that the outcome of pending and threatened litigation and inquiries will not have a material effect on Regions' business, consolidated financial position, results of operations or cash flows as a whole. However, in the event of unexpected future developments, it is reasonably possible that an adverse outcome in any of the matters discussed above could be material to Regions’ business, consolidated financial position, results of operations or cash flows for any particular reporting period of occurrence.

GUARANTEES

INDEMNIFICATION OBLIGATION

As discussed in Note 2, on April 2, 2012 (“Closing Date”), Regions closed the sale of Morgan Keegan and related affiliates to Raymond James. In connection with the sale, Regions agreed to indemnify Raymond James for all legal matters related to pre-closing activities, including matters filed subsequent to the Closing Date that relate to actions that occurred prior to closing. Losses under the indemnification include legal and other expenses, such as costs for judgments, settlements and awards associated with the defense and resolution of the indemnified matters. The maximum potential amount of future payments that Regions could be required to make under the indemnification is indeterminable due to the indefinite term of some of the obligations. However, Regions expects the majority of ongoing legal matters related to the indemnification to be resolved within approximately one to two years.

As of the Closing Date, the fair value of the indemnification obligation, which includes defense costs and unasserted claims, was approximately $385 million, of which approximately $256 million was recognized as a reduction to the gain on sale of Morgan Keegan. The fair value was determined through the use of a present value calculation that takes into account the future cash flows that a market participant would expect to receive from holding the indemnification liability as an asset. Regions performed a probability-weighted cash flow analysis and discounted the result at a credit-adjusted risk free rate. The fair value of the indemnification liability includes amounts that Regions had previously determined meet the definition of probable and reasonably estimable. Adjustments to the indemnification obligation are recorded within professional and legal expenses within discontinued operations (see Note 2). As of March 31, 2015, the carrying value of the indemnification obligation was approximately $204 million.

VISA INDEMNIFICATION

As a member of the Visa USA network, Regions, along with other members, indemnified Visa USA against litigation. On October 3, 2007, Visa USA was restructured and acquired several Visa affiliates. In conjunction with this restructuring, Regions' indemnification of Visa USA was modified to cover specific litigation (“covered litigation”). A portion of Visa's proceeds from its initial public offering ("IPO") was put into escrow to fund the covered litigation. To the extent that the amount available under the escrow arrangement, or subsequent fundings of the escrow account resulting from reductions in the class B share conversion ratio, is insufficient to fully resolve the covered litigation, Visa will enforce the indemnification obligations of Visa USA's members for any excess amount. At this time, Regions has concluded that it is not probable that covered litigation exposure will exceed the class B share value.

NOTE 15. RECENT ACCOUNTING PRONOUNCEMENTS

In January 2014, the FASB issued new accounting guidance related to the accounting for investments in qualified affordable housing projects. The guidance allows the holder of low income housing tax credit ("LIHTC") investments to apply a proportional amortization method, which recognizes the amortized cost of the investment as a component of income tax expense, provided that the investment meets certain criteria. The guidance is silent regarding balance sheet classification. Regions believes it would not be appropriate to classify the investment as a deferred tax asset. The decision to apply the proportional amortization method is an accounting policy election. Entities may also elect to continue to account for these investments using the equity method. The guidance became effective for fiscal years, and interim periods within those years, beginning after December 15, 2014 and was adopted by Regions for financial reporting beginning with the first quarter of 2015. The adoption is required to be applied retrospectively to all prior periods presented. The cumulative effect to retained earnings (deficit) as of January 1, 2015 of adopting this guidance was reduction of $116 million. Refer to Note 1 for additional information.

In January 2014, the FASB issued new accounting guidance regarding the reclassification of residential real estate collateralized consumer mortgage loans upon foreclosures. The guidance requires reclassification of a consumer mortgage loan to other real estate owned upon obtaining legal title to the residential property, which could occur either through foreclosure or through a deed in lieu of foreclosure or similar legal agreement. The existence of a borrower redemption right will not prevent the lender from reclassifying a loan to other real estate once the lender obtains legal title to the property. In addition, entities are required to disclose the amount of foreclosed residential real estate

properties and the recorded investment in residential real estate mortgage loans in the process of foreclosure on both an interim and annual basis. This guidance became effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2014 and was adopted by Regions on a prospective basis with the first quarter of 2015 reporting. This guidance did not have a material impact upon adoption.
In June 2014, the FASB issued new accounting guidance that requires two accounting changes related to the transfer and servicing of repurchase agreements and similar transactions. First, the amendments in the update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. Second, for repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement

with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The amendments in the update also require certain disclosures for transfers of financial assets and repurchase agreements. The disclosure of certain transactions accounted for as a sale is required to be presented for fiscal years and interim periods within those years beginning after December 15, 2014 and the disclosure for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowing is required to be presented for fiscal years beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. The accounting changes were effective for fiscal years and interim periods within those years beginning after December 15, 2014 and were adopted by Regions with the first quarter 2015 reporting. This guidance did not have a material impact upon adoption.

In August 2014, the FASB issued new accounting guidance regarding the classification and measurement of foreclosed mortgage loans that are guaranteed by the government (including loans guaranteed by the FHA and the VA). The guidance addresses diversity in practice by requiring creditors to derecognize the mortgage loan upon foreclosure and to recognize a separate other receivable if the following conditions are met: (a) the government guarantee of the loan is not separable from the loan before foreclosure; (b) upon foreclosure, the creditor has the intent to convey the real estate to the guarantor and to make a claim on the guarantee, and also has the ability to make a recovery under the claim; and (c) claim amounts based on the fair value of the property are fixed upon foreclosure. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This guidance became effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2014 and was adopted by Regions on a prospective basis with the first quarter of 2015 reporting. This guidance did not have a material impact upon adoption.

In August 2014, the FASB issued new accounting guidance to offer a measurement alternative for reporting entities that consolidate a collateralized financing entity ("CFE") in which the financial assets and financial liabilities are measured at fair value, with changes in fair values reflected in earnings. Under the measurement alternative, the reporting entity could elect to measure both the CFE’s financial assets and financial liabilities using the fair value of either the CFE’s financial assets or financial liabilities, whichever is more observable. This guidance became effective for the first quarter of 2015 financial reporting period. This guidance did not have a material impact upon adoption.

In February 2015, the FASB issued new accounting guidance that eliminates the consolidation model created specifically for limited partnerships and creates a single model for evaluating consolidation of legal entities. The new guidance does the following: (a) modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities; (b) eliminates the presumption that a general partner should consolidate a limited partnership; (c) modifies the consolidation analysis for all reporting entities associated with VIEs, particularly those that have fee arrangements and related party relationships; and (d) provides a scope exception from the consolidation guidance for reporting entities with interests in legal entities that are similar to investment companies as defined in the Investment Company Act of 1940. The guidance is effective for annual and interim periods beginning after December 15, 2015. Early adoption is permitted. Regions believes the adoption of this guidance will not have a material impact to its consolidated financial statements.

Further information related to recent accounting pronouncements and accounting changes adopted by Regions prior to the first quarter of 2015 is included in the Annual Report on Form 10-K for the year ended December 31, 2014.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

The following discussion and analysis is part of Regions Financial Corporation's ("Regions" or the "Company") Quarterly Report on Form 10-Q to the Securities and Exchange Commission ("SEC") and updates Regions' Annual Report on Form 10-K for the year ended December 31, 2014, which was previously filed with the SEC. This financial information is presented to aid in understanding Regions' financial position and results of operations and should be read together with the financial information contained in the Form 10-K. Effective January 1, 2015, the Company adopted new guidance related to the accounting for investments in qualified affordable housing projects. The guidance required retrospective application. All prior period amounts impacted by this guidance have been revised. Certain other prior period amounts presented in this discussion and analysis have been reclassified to conform to current period classifications, except as otherwise noted. The emphasis of this discussion will be on the three months ended March 31, 2015 compared to the three months ended March 31, 2014 for the consolidated statements of income. For the consolidated balance sheet, the emphasis of this discussion will be the balances as of March 31, 2015 compared to December 31, 2014.

This discussion and analysis contains statements that may be considered "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. See pages 3 and 4 for additional information regarding forward-looking statements.

CORPORATE PROFILE

Regions is a financial holding company headquartered in Birmingham, Alabama, which operates in the South, Midwest and Texas. Regions provides traditional commercial, retail and mortgage banking services, as well as other financial services in the fields of asset management, wealth management, securities brokerage, insurance, trust services and other specialty financing.

Regions conducts its banking operations through Regions Bank, an Alabama state-chartered commercial bank that is a member of the Federal Reserve System. At March 31, 2015, Regions operated 1,633 total branch outlets in Alabama, Arkansas, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, South Carolina, Tennessee, Texas and Virginia. Regions operates under three reportable business segments: Corporate Bank, Consumer Bank, and Wealth Management with the remainder split between Discontinued Operations and Other. See Note 13 "Business Segment Information" to the consolidated financial statements for more information regarding Regions' segment reporting structure. Regions also provides full-line insurance brokerage services primarily through Regions Insurance, Inc. which is included in the Wealth Management segment.

On January 11, 2012, Regions entered into a stock purchase agreement to sell Morgan Keegan & Company, Inc. ("Morgan Keegan") and related affiliates to Raymond James Financial, Inc. ("Raymond James"). The sale closed on April 2, 2012. Regions Investment Management, Inc. and Regions Trust were not included in the sale; they are included in the Wealth Management segment. See Note 2 "Discontinued Operations" to the consolidated financial statements for further discussion.

Regions' profitability, like that of many other financial institutions, is dependent on its ability to generate revenue from net interest income and non-interest income sources. Net interest income is the difference between the interest income Regions receives on interest-earning assets, such as loans and securities, and the interest expense Regions pays on interest-bearing liabilities, principally deposits and borrowings. Regions' net interest income is impacted by the size and mix of its balance sheet components and the interest rate spread between interest earned on its assets and interest paid on its liabilities. Non-interest income includes fees from service charges on deposit accounts, card and ATM fees, mortgage servicing and secondary marketing, investment management and trust activities, insurance activities, capital markets, and other customer services which Regions provides. Results of operations are also affected by the provision for loan losses and non-interest expenses such as salaries and employee benefits, occupancy, professional, legal and regulatory expenses, deposit administrative fees, and other operating expenses, as well as income taxes.

Economic conditions, competition, new legislation and related rules impacting regulation of the financial services industry and the monetary and fiscal policies of the Federal government significantly affect most, if not all, financial institutions, including Regions. Lending and deposit activities and fee income generation are influenced by levels of business spending and investment, consumer income, consumer spending and savings, capital market activities, and competition among financial institutions, as well as customer preferences, interest rate conditions and prevailing market rates on competing products in Regions’ market areas.

Regions’ business strategy has been and continues to be focused on providing a competitive mix of products and services, delivering quality customer service and maintaining a branch distribution network with offices in convenient locations.

FIRST QUARTER OVERVIEW

Regions reported net income available to common shareholders of $218 million, or 0.16 per diluted share, in the first quarter of 2015 compared to net income available to common shareholders of $307 million, or 0.22 per diluted share, in the first quarter of 2014. Increased provision for loan losses as well as increased non-interest expense were the primary drivers in the decline in results from the prior year period.

For the first quarter of 2015, net interest income (taxable-equivalent basis) from continuing operations totaled $832 million, essentially flat compared to the first quarter of 2014. The net interest margin (taxable-equivalent basis) was 3.18 percent for the first quarter of 2015 and 3.26 percent in the first quarter of 2014. Although the average balance of loans increased for the first quarter of 2015 compared to the first quarter of 2014, loan yields declined. The average balance of other interest-earning assets, which consists primarily of excess cash held at the Federal Reserve, decreased during this period, while the yield on these balances remained flat at 28 basis points. Rates paid on interest-bearing liabilities declined during this period, but not enough to offset a 13 basis point reduction in yield on total earning assets. These factors collectively drove the 8 basis point compression in net interest margin. Total deposit costs were 12 basis points for both the first quarter of 2015 and 2014. Total funding costs, which include deposits, short-term borrowings and long-term debt, were 29 basis points for the first quarter of 2015, as compared to 33 basis points for the first quarter of 2014, reflecting liability management efforts completed by the Company.

The provision for loan losses totaled $49 million in the first quarter of 2015 compared to $2 million during the first quarter of 2014. The increase in provision expense during the first quarter of 2015 compared to the 2014 period was primarily due to an increase in criticized and classified loans in the first quarter of 2015 compared to year-end 2014 consisting of a small number of larger dollar commercial and industrial loans within the energy, healthcare and other portfolios. Given the current phase of the credit cycle, volatility in certain credit metrics is to be expected.

Net charge-offs totaled $54 million, or an annualized 0.28 percent of average loans, in the first quarter of 2015, compared to $82 million, or an annualized 0.44 percent for the first quarter of 2014. Net charge-offs were lower across most major loan categories when comparing the first quarter of 2015 period to the prior year period.

The allowance for loan losses at March 31, 2015 was 1.40 percent of total loans, net of unearned income, compared to 1.43 percent at December 31, 2014. Total non-performing assets were $970 million at March 31, 2015, compared to $991 million at December 31, 2014.

Non-interest income from continuing operations for the first quarter of 2015 was $470 million, compared to $457 million for the first quarter of 2014. This increase was driven by modest gains in most non-interest income categories which was partially offset by a decrease in service charges on deposit accounts.

Total non-interest expense from continuing operations was $905 million in the first quarter of 2015, an $88 million increase from the first quarter of 2014, driven primarily by a $43 million loss on early extinguishment of debt and $22 million in branch consolidation, property and equipment charges incurred in the first quarter of 2015 compared to $6 million in the first quarter of 2014. Also contributing to the period over period increase was a gain of $35 million recognized from the sale of troubled debt restructurings ("TDRs") held for sale during the first quarter of 2014.

Income tax expense from continuing operations for the three months ended March 31, 2015 was $95 million compared to income tax expense of $151 million for the same period in 2014. Income tax expense was lower in the current period as compared to the prior comparable period principally due to lower pre-tax income and an income tax benefit of approximately $10 million related to net state deferred tax assets.

A discussion of activity within discontinued operations is included at the end of the Management’s Discussion and Analysis section of this report.

TOTAL ASSETS

Regions’ total assets at March 31, 2015 were $122.4 billion, compared to $119.6 billion at December 31, 2014. The increase in total assets from year-end 2014 resulted primarily from a $1.9 billion increase in interest-bearing deposits held in other banks and a $936 million increase in loans. Funding for this asset growth came primarily from increases in low-cost deposits.

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SECURITIES

The following table details the carrying values of securities, including both available for sale and held to maturity:

Table 1—Securities

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (In millions) | |
| U.S. Treasury securities | $181 | $177 |
| Federal agency securities | 572 | 573 |
| Obligations of states and political subdivisions | 2 | 2 |
| Mortgage-backed securities: | | |
| Residential agency | 17,739 | 17,665 |
| Residential non-agency | 7 | 8 |
| Commercial agency | 2,194 | 2,173 |
| Commercial non-agency | 1,556 | 1,494 |
| Corporate and other debt securities | 2,074 | 1,990 |
| Equity securities | 683 | 673 |
| | $25,008 | $24,755 |

Regions maintains a highly rated securities portfolio consisting primarily of agency mortgage-backed securities. Total securities at March 31, 2015 increased $253 million from year-end 2014 primarily due to market rate improvements in the fair value of the available for sale securities portfolio as well as marginal additional portfolio purchases. Securities available for sale, which constitute the majority of the securities portfolio, are an important tool used to manage interest rate sensitivity and provide a primary source of liquidity for the Company. See the "Market Risk-Interest Rate Risk" and "Liquidity Risk" sections for more information.

LOANS HELD FOR SALE

Loans held for sale totaled $491 million at March 31, 2015, consisting primarily of $397 million of residential real estate mortgage loans, $60 million of commercial mortgage loans in the process of being sold to Fannie Mae through Regions' Fannie Mae Delegated Underwriting and Servicing ("DUS") program, and $32 million of non-performing loans. At December 31, 2014, loans held for sale totaled $541 million, consisting primarily of $442 million of residential real estate mortgage loans, $61 million of commercial mortgage loans in the process of being sold to Fannie Mae through Regions' Fannie Mae DUS program, and $38 million of non-performing loans. The level of residential real estate mortgage loans held for sale that are part of the Company's mortgage originations to be sold in the secondary market fluctuates depending on the timing of origination and sale to third parties.

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LOANS

Loans, net of unearned income, represented approximately 72 percent of Regions' interest-earning assets at March 31, 2015. The following table presents the distribution of Regions' loan portfolio by portfolio segment and class, net of unearned income:

Table 2—Loan Portfolio

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (In millions, net of unearned income) | |
| Commercial and industrial | $33,681 | $32,732 |
| Commercial real estate mortgage—owner-occupied | 8,043 | 8,263 |
| Commercial real estate construction—owner-occupied | 437 | 407 |
| Total commercial | 42,161 | 41,402 |
| Commercial investor real estate mortgage | 4,499 | 4,680 |
| Commercial investor real estate construction | 2,422 | 2,133 |
| Total investor real estate | 6,921 | 6,813 |
| Residential first mortgage | 12,418 | 12,315 |
| Home equity | 10,854 | 10,932 |
| Indirect | 3,701 | 3,642 |
| Consumer credit card | 966 | 1,009 |
| Other consumer | 1,222 | 1,194 |
| Total consumer | 29,161 | 29,092 |
| | $78,243 | $77,307 |

PORTFOLIO CHARACTERISTICS

The following sections describe the composition of the portfolio segments and classes disclosed in Table 2, explain changes in balances from the 2014 year-end, and highlight the related risk characteristics. Regions believes that its loan portfolio is well diversified by product, client, and geography throughout its footprint. However, the loan portfolio may be exposed to certain concentrations of credit risk which exist in relation to individual borrowers or groups of borrowers, certain types of collateral, certain types of industries, certain loan products, or certain regions of the country. See Note 4 "Loans and the Allowance for Credit Losses" to the consolidated financial statements for additional discussion.

Commercial—The commercial portfolio segment includes commercial and industrial loans to commercial customers for use in normal business operations to finance working capital needs, equipment purchases and other expansion projects. Commercial and industrial loans increased $949 million or 3 percent since year-end driven primarily by Regions' market based corporate and commercial bankers serving middle market clients and the Company's asset based lending and corporate real estate groups. Commercial also includes owner-occupied commercial real estate mortgage loans to operating businesses, which are loans for long-term financing of land and buildings, and are repaid by cash flow generated by business operations. These loans declined $220 million or 3 percent from year-end 2014 as a result of continued customer deleveraging. Owner-occupied construction loans are made to commercial businesses for the development of land or construction of a building where the repayment is derived from revenues generated from the business of the borrower.

The commercial portfolio segment generated the majority of the Company's loan growth in the first three months of 2015, particularly commercial and industrial loans. Over half of the Company's total loans are included in the commercial portfolio segment. These balances are spread across numerous industries, as disclosed in "Table 11—Selected Industry Balances" in the Annual Report on Form 10-K for the year ended December 31, 2014. The Company manages the related risks to this portfolio by setting certain lending limits for each significant industry. At March 31, 2015 and December 31, 2014, no single industry exceeded 15 percent of the total commercial portfolio balance.

Beginning late in 2014, oil prices began declining, and Regions has been monitoring the prices for both direct and indirect impacts on its energy lending portfolio. Regions' energy industry loan balances at March 31, 2015 were approximately $2.8 billion. This amount is comprised of loans directly related to energy, such as oilfield services, exploration and production, and pipeline transportation of gas and crude oil. Other types of lending are tangentially impacted by the energy portfolio, such as petroleum wholesalers, oil and gas equipment manufacturing, air transportation, and petroleum bulk stations and terminals. The entire energy-related portfolio, combining direct and indirect exposures, was approximately $3.3 billion at March 31, 2015. These loans are geographically concentrated primarily in Texas and, to a lesser extent, in South Louisiana. Regions employs a variety of risk management strategies, including the use of concentration limits and continuous monitoring, as well as utilizing underwriting with borrowing base structures tied to energy commodity reserve bases or other tangible assets. Regions also employs experienced lending and underwriting teams including petroleum engineers, all with extensive energy sector experience through multiple economic cycles. If the current low level of oil prices continues, this energy-related portfolio may be subject to additional pressure on credit quality metrics including past due, criticized, and non-performing loans, as well as net charge-offs.

Investor Real Estate—Loans for real estate development are repaid through cash flow related to the operation, sale or refinance of the property. This portfolio segment includes extensions of credit to real estate developers or investors where repayment is dependent on the sale of real estate or income generated from the real estate collateral. A portion of Regions' investor real estate portfolio segment consists of loans secured by residential product types (land, single-family and condominium loans) within Regions' markets. Additionally, this category includes loans made to finance income-producing properties such as apartment buildings, office and industrial buildings, and retail shopping centers. Total investor real estate loans increased $108 million from 2014 year-end balances.

Due to the nature of the cash flows typically used to repay investor real estate loans, these loans are particularly vulnerable to weak economic conditions. As a result, this loan type has a higher risk of non-collection than other loans.

The Company has made considerable efforts to de-risk its balance sheet. A primary focus has been reducing the Company's exposure in the investor real estate portfolio. Total investor real estate loans represented approximately 24 percent of total loans at December 31, 2008, and has been actively managed down to approximately 9 percent of total loans at March 31, 2015. Investor real estate lending remains an important part of the Company's lending strategy based on its market presence in the southeast United States; however, strict underwriting requirements and exposure limits will be maintained.

Residential First Mortgage—Residential first mortgage loans represent loans to consumers to finance a residence. These loans are typically financed over a 15 to 30 year term and, in most cases, are extended to borrowers to finance their primary residence. These loans experienced a $103 million increase from year-end 2014, as prepayments have slowed. Approximately $702 million in new loan originations were retained on the balance sheet through the first quarter of 2015.

Home Equity—Home equity lending includes both home equity loans and lines of credit. This type of lending, which is secured by a first or second mortgage on the borrower's residence, allows customers to borrow against the equity in their homes. The home equity portfolio totaled $10.9 billion at both March 31, 2015 and December 31, 2014. Substantially all of this portfolio was originated through Regions' branch network.

The following table presents information regarding the future principal payment reset dates for the Company's home equity lines of credit as of March 31, 2015. The balances presented are based on maturity date for lines with a balloon payment and draw period expiration date for lines that convert to a repayment period.

Table 3—Home Equity Lines of Credit - Future Principal Payment Resets

| | First Lien | % of Total | | Second Lien | % of Total | | Total |
|---|---|---|---|---|---|---|---|
| | (Dollars in millions) | | | | | | |
| 2015 | $20 | 0.24 | % | $139 | 1.68 | % | $159 |
| 2016 | 28 | 0.34 | | 36 | 0.44 | | 64 |
| 2017 | 5 | 0.06 | | 11 | 0.13 | | 16 |
| 2018 | 15 | 0.18 | | 24 | 0.29 | | 39 |
| 2019 | 105 | 1.27 | | 92 | 1.11 | | 197 |
| 2020-2024 | 1,438 | 17.35 | | 1,298 | 15.66 | | 2,736 |
| 2025-2029 | 2,425 | 29.27 | | 2,647 | 31.95 | | 5,072 |
| Thereafter | 1 | 0.01 | | 2 | 0.02 | | 3 |
| Total | $4,037 | 48.72 | % | $4,249 | 51.28 | % | $8,286 |

Of the $10.9 billion home equity portfolio at March 31, 2015, approximately $8.3 billion were home equity lines of credit and $2.6 billion were closed-end home equity loans (primarily originated as amortizing loans). Beginning in May 2009, new home equity lines of credit have a 10-year draw period and a 10-year repayment period. Previously, the home equity lines of credit had a 20-year term with a balloon payment upon maturity or a 5-year draw period with a balloon payment upon maturity. The term "balloon payment" means there are no principal payments required until the balloon payment is due for interest-only lines of credit. As of March 31, 2015, none of Regions' home equity lines of credit have converted to mandatory amortization under the contractual terms. As presented in the table above, the majority of home equity lines of credit will either mature with a balloon payment or convert to amortizing status after fiscal year 2020.

Of the $8.3 billion of home equity lines of credit as of March 31, 2015, approximately 91 percent require monthly interest-only payments while the remaining approximately 9 percent require a payment equal to 1.5 percent of the outstanding balance, which would include some principal repayment. As of March 31, 2015, approximately 29 percent of borrowers were only paying the minimum amount due on the home equity line. In addition, approximately 60 percent of the home equity lines of credit balances

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have the option to amortize either all or a portion of their balance. As of March 31, 2015, approximately $261 million of the home equity line of credit balances have elected this option.

Regions is unable to track payment status on first liens held by another institution, including payment status related to loan modifications. When Regions' second lien position becomes delinquent, an attempt is made to contact the first lien holder and inquire as to the payment status of the first lien. However, Regions does not continuously monitor the payment status of the first lien position. Short sale offers and settlement agreements are often received by the home equity junior lien holders well before the loan balance reaches the delinquency threshold for charge-off consideration, potentially resulting in a full balance payoff/charge-off. Regions is presently monitoring the status of all first lien position loans that the Company owns or services and has a second lien, and is taking appropriate action when delinquent. Regions services the first lien on approximately 24 percent of the entire second lien home equity portfolio as of March 31, 2015.

Other Consumer Credit Quality Data

The Company calculates an estimate of the current value of property secured as collateral for both residential first mortgage and home equity lending products ("current LTV"). The estimate is based on home price indices compiled by a third party. The third party data indicates trends for Metropolitan Statistical Areas ("MSAs"). Regions uses the third party valuation trends from the MSAs in the Company's footprint in its estimate. The trend data is applied to the loan portfolios taking into account the age of the most recent valuation and geographic area.

The following table presents current LTV data for components of the residential first mortgage and home equity classes of the consumer portfolio segment. Current LTV data for the remaining loans in the portfolio is not available, primarily because some of the loans are serviced by others. Data may also not be available due to mergers and systems integrations. The amounts in the table represent the entire loan balance. For purposes of the table below, if the loan balance exceeds the current estimated collateral, the entire balance is included in the "Above 100%" category, regardless of the amount of collateral available to partially offset the shortfall. The balances in the "Above 100%" category as a percentage of the portfolio balances remained at 4 percent in the residential first mortgage portfolio and remained at 8 percent in the home equity portfolio when comparing March 31, 2015 to December 31, 2014, respectively.

Table 4—Estimated Current Loan to Value Ranges

| | March 31, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|---|
| | Residential First Mortgage | Home Equity 1st Lien | 2nd Lien | Residential First Mortgage | Home Equity 1st Lien | 2nd Lien |
| | (In millions) | | | | | |
| Estimated current loan to value: | | | | | | |
| Above 100% | $449 | $195 | $628 | $435 | $198 | $633 |
| 80% - 100% | 1,788 | 554 | 1,062 | 1,743 | 536 | 1,078 |
| Below 80% | 9,668 | 5,386 | 2,630 | 9,626 | 5,282 | 2,696 |
| Data not available | 513 | 126 | 273 | 511 | 179 | 330 |
| | $12,418 | $6,261 | $4,593 | $12,315 | $6,195 | $4,737 |

Indirect

Indirect lending, which is lending initiated through third-party business partners, largely consists of loans made through automotive dealerships. This portfolio class increased $59 million from year-end 2014, reflecting continued growing demand for automobile loans.

Consumer Credit Card

Consumer credit card lending represents primarily open-ended variable interest rate consumer credit card loans. These balances experienced a seasonal decline of $43 million from year-end 2014.

Other Consumer

Other consumer loans primarily include direct consumer loans, overdrafts and other revolving loans. Other consumer loans increased $28 million from year-end 2014.

Regions qualitatively considers factors such as periodic updates of FICO scores, unemployment, home prices, and geography as credit quality indicators for consumer loans. FICO scores are obtained at origination as part of Regions' formal underwriting process. Refreshed FICO scores are obtained by the Company quarterly for all revolving accounts and home equity lines of credit and semi-annually for all other consumer loans. The following tables present estimated current FICO score data for components of classes of the consumer portfolio segment. Current FICO data is not available for the remaining loans in the portfolio for various reasons; for example, if customers do not use sufficient credit, an updated score may not be available. Residential first mortgage and home equity balances with FICO scores below 620 were 6 percent of the combined portfolios for both March 31, 2015 and December 31, 2014.

Table 5—Estimated Current FICO Score Ranges

| | March 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Residential First Mortgage | Home Equity 1st Lien | 2nd Lien | Indirect | Consumer Credit Card | Other Consumer |
| | (In millions) | | | | | |
| Below 620 | $818 | $338 | $307 | $360 | $52 | $89 |
| 620-680 | 1,029 | 550 | 481 | 506 | 147 | 150 |
| 681-720 | 1,407 | 758 | 585 | 569 | 228 | 194 |
| Above 720 | 8,255 | 4,444 | 3,116 | 2,083 | 539 | 496 |
| Data not available | 909 | 171 | 104 | 183 | — | 293 |
| | $12,418 | $6,261 | $4,593 | $3,701 | $966 | $1,222 |
| | December 31, 2014 | | | | | |
| | Residential First Mortgage | Home Equity 1st Lien | 2nd Lien | Indirect | Consumer Credit Card | Other Consumer |
| | (In millions) | | | | | |
| Below 620 | $827 | $345 | $318 | $377 | $52 | $82 |
| 620-680 | 1,031 | 544 | 491 | 500 | 150 | 140 |
| 681-720 | 1,355 | 740 | 617 | 550 | 231 | 181 |
| Above 720 | 8,228 | 4,337 | 3,162 | 2,032 | 575 | 475 |
| Data not available | 874 | 229 | 149 | 183 | 1 | 316 |
| | $12,315 | $6,195 | $4,737 | $3,642 | $1,009 | $1,194 |

ALLOWANCE FOR CREDIT LOSSES

The allowance for credit losses ("allowance") consists of two components: the allowance for loan and lease losses and the reserve for unfunded credit commitments. The allowance represents management’s estimate of probable credit losses inherent in the loan and credit commitment portfolios as of period end. Regions determines its allowance in accordance with applicable accounting literature as well as regulatory guidance related to receivables and contingencies. Binding unfunded credit commitments include items such as letters of credit, financial guarantees and binding unfunded loan commitments. Additional discussion of the methodology used to calculate the allowance is included in Note 1 “Summary of Significant Accounting Policies” and Note 6 “Allowance for Credit Losses” to the consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2014, as well as related discussion in Management’s Discussion and Analysis.

The allowance for loan losses totaled $1.1 billion at both March 31, 2015 and December 31, 2014. The allowance for loan losses as a percentage of net loans was 1.40 percent at March 31, 2015 and 1.43 percent at December 31, 2014. The reserve for unfunded credit commitments was $66 million at March 31, 2015 and $65 million at December 31, 2014. Net charge-offs as a percentage of average loans (annualized) were 0.28 percent and 0.44 percent in the first three months of 2015 and 2014, respectively. Net charge-offs were lower across most categories, period over period. The provision for loan losses totaled $49 million for the first quarter of 2015 compared to $2 million for the first quarter of 2014. During the first quarter of 2015, net charge-offs exceeded the provision for loan losses by approximately $5 million compared to approximately $80 million for the 2014 period. The difference reflects an increase in criticized and classified loans in the first quarter of 2015 compared to year-end 2014 consisting of a small number of larger dollar commercial and industrial loans within the energy, healthcare and other portfolios. Given the current phase of the credit cycle, volatility in certain credit metrics is to be expected.

Management considers the current level of the allowance appropriate to absorb losses inherent in the loan and credit commitment portfolios. Management’s determination of the appropriateness of the allowance requires the use of judgments and estimations that may change in the future. Changes in the factors used by management to determine the appropriateness of the allowance or the availability of new information could cause the allowance to be increased or decreased in future periods. Management expects the allowance for credit losses to total loans ratio to vary over time due to changes in portfolio balances, economic conditions, loan mix and collateral values, or variations in other factors that may affect inherent losses. In addition, bank regulatory agencies, as part of their examination process, may require changes in the level of the allowance based on their judgments and estimates.

Management expects that net loan charge-offs in 2015 will decline somewhat compared to those experienced in 2014; however, economic trends such as real estate valuations, interest rates, unemployment and volatility in commodity prices will impact the future levels of net charge-offs and provision and may result in volatility during the remainder of 2015. Additionally, changes in circumstances related to individually large credits or certain portfolios may result in volatility. Details regarding the allowance and net charge-offs, including an analysis of activity from the previous year’s totals, are included in Table 6 “Allowance for Credit Losses.”

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Activity in the allowance for credit losses is summarized as follows:
Table 6—Allowance for Credit Losses

| | Three Months Ended March 31 | |
|---|---|---|
| | 2015 | 2014 |
| | (Dollars in millions) | |
| Allowance for loan losses at beginning of year | $1,103 | $1,341 |
| Loans charged-off: | | |
| Commercial and industrial | 27 | 24 |
| Commercial real estate mortgage—owner-occupied | 7 | 16 |
| Commercial real estate construction—owner-occupied | — | 1 |
| Commercial investor real estate mortgage | 8 | 8 |
| Commercial investor real estate construction | — | 1 |
| Residential first mortgage | 7 | 11 |
| Home equity | 17 | 28 |
| Indirect | 10 | 10 |
| Consumer credit card | 10 | 9 |
| Other consumer | 15 | 16 |
| | 101 | 124 |
| Recoveries of loans previously charged-off: | | |
| Commercial and industrial | 11 | 14 |
| Commercial real estate mortgage—owner-occupied | 6 | 3 |
| Commercial real estate construction—owner-occupied | — | — |
| Commercial investor real estate mortgage | 6 | 7 |
| Commercial investor real estate construction | 2 | 1 |
| Residential first mortgage | 4 | 2 |
| Home equity | 7 | 7 |
| Indirect | 4 | 3 |
| Consumer credit card | 2 | 1 |
| Other consumer | 5 | 4 |
| | 47 | 42 |
| Net charge-offs: | | |
| Commercial and industrial | 16 | 10 |
| Commercial real estate mortgage—owner-occupied | 1 | 13 |
| Commercial real estate construction—owner-occupied | — | 1 |
| Commercial investor real estate mortgage | 2 | 1 |
| Commercial investor real estate construction | (2) | — |
| Residential first mortgage | 3 | 9 |
| Home equity | 10 | 21 |
| Indirect | 6 | 7 |
| Consumer credit card | 8 | 8 |
| Other consumer | 10 | 12 |
| | 54 | 82 |
| Provision for loan losses | 49 | 2 |
| Allowance for loan losses at March 31 | $1,098 | $1,261 |
| Reserve for unfunded credit commitments at beginning of year | $65 | $78 |
| Provision (credit) for unfunded credit losses | 1 | — |
| Reserve for unfunded credit commitments at March 31 | $66 | $78 |
| Allowance for credit losses at March 31 | $1,164 | $1,339 |

| | | | | |
|---|---|---|---|---|
| Loans, net of unearned income, outstanding at end of period | $78,243 | | $75,680 | |
| Average loans, net of unearned income, outstanding for the period | $77,942 | | $75,139 | |
| Ratios: | | | | |
| Allowance for loan losses at end of period to loans, net of unearned income | 1.40 | % | 1.67 | % |
| Allowance for loan losses at end of period to non-performing loans, excluding loans held for sale | 1.37x | | 1.18x | |
| Net charge-offs as percentage of average loans, net of unearned income (annualized) | 0.28 | % | 0.44 | % |

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TROUBLED DEBT RESTRUCTURINGS (TDRs)

TDRs are modified loans in which a concession is provided to a borrower experiencing financial difficulty. Residential first mortgage, home equity, direct, indirect, consumer credit card and other consumer TDRs are consumer loans modified under the Customer Assistance Program ("CAP"). Commercial and investor real estate loan modifications are not the result of a formal program, but represent situations where a modification was offered as a workout alternative. Renewals of classified commercial and investor real estate loans are considered to be TDRs, even if no reduction in interest rate is offered, if the existing terms are considered to be below market. More detailed information is included in Note 4 "Loans and the Allowance For Credit Losses" to the consolidated financial statements. The following table summarizes TDRs for the periods presented:

Table 7—Troubled Debt Restructurings

| | March 31, 2015 | | December 31, 2014 | |
|---|---|---|---|---|
| | Loan Balance | Allowance for Loan Losses | Loan Balance | Allowance for Loan Losses |
| | (In millions) | | | |
| Accruing: | | | | |
| Commercial | $249 | $35 | $251 | $33 |
| Investor real estate | 234 | 30 | 290 | 34 |
| Residential first mortgage | 382 | 50 | 356 | 49 |
| Home equity | 337 | 10 | 343 | 12 |
| Indirect | 1 | — | 1 | — |
| Consumer credit card | 2 | — | 2 | — |
| Other consumer | 15 | — | 17 | — |
| | 1,220 | 125 | 1,260 | 128 |
| Non-accrual status or 90 days past due and still accruing: | | | | |
| Commercial | 104 | 24 | 93 | 24 |
| Investor real estate | 42 | 8 | 67 | 15 |
| Residential first mortgage | 96 | 13 | 112 | 15 |
| Home equity | 24 | 1 | 25 | 1 |
| | 266 | 46 | 297 | 55 |
| Total TDRs - Loans | $1,486 | $171 | $1,557 | $183 |
| | | | | |
| TDRs - Held For Sale | 19 | — | 29 | — |
| Total TDRs | $1,505 | $171 | $1,586 | $183 |

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Note: All loans listed in the table above are considered impaired under applicable accounting literature.

The following table provides an analysis of the changes in commercial and investor real estate TDRs. Loans that may be modified more than once are reported as TDR inflows only in the period they are first modified. Other than resolutions such as charge-offs, foreclosures, sales and transfers to held for sale, Regions may remove loans held for investment from TDR classification, but only if the borrower's financial condition improves such that the borrower is no longer in financial difficulty, the loan has not had any forgiveness of principal or interest, and the loan is subsequently refinanced or restructured at market terms and qualifies as a new loan.

For the consumer portfolio, changes in TDRs are primarily due to inflows from CAP modifications and outflows from payments and charge-offs. Given the types of concessions currently being granted under the CAP, as detailed in Note 4 “Loans and the Allowance for Credit Losses” to the consolidated financial statements, Regions does not expect that the market interest rate condition will be widely achieved. Therefore, Regions expects consumer loans modified through CAP to continue to be identified as TDRs for the remaining term of the loan.

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Table 8—Analysis of Changes in Commercial and Investor Real Estate TDRs

| | Three Months Ended March 31, 2015 | |
|---|---|---|
| | Commercial | Investor Real Estate |
| | (In millions) | |
| Balance, beginning of period | $344 | $357 |
| Inflows | 70 | 12 |
| Outflows | | |
| Charge-offs | (4) | (5) |
| Foreclosure | — | (14) |
| Payments, sales and other [1] | (57) | (74) |
| Balance, end of period | $353 | $276 |

| | Three Months Ended March 31, 2014 | |
|---|---|---|
| | Commercial | Investor Real Estate |
| | (In millions) | |
| Balance, beginning of period | $624 | $668 |
| Inflows | 67 | 21 |
| Outflows | | |
| Charge-offs | (9) | (4) |
| Foreclosure | — | (1) |
| Payments, sales and other [1] | (49) | (80) |
| Balance, end of period | $633 | $604 |

(1) The majority of this category consists of payments and sales. "Other" outflows include normal amortization/accretion of loan basis adjustments and loans transferred to held for sale. It also includes $17 million of commercial loans and $18 million of investor real estate loans refinanced or restructured as new loans and removed from TDR classification for the three months ended March 31, 2015. No loans were removed from TDR classification in the first quarter of 2014 as a result of being refinanced or restructured as new loans.

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NON-PERFORMING ASSETS

Non-performing assets are summarized as follows:

Table 9—Non-Performing Assets

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (Dollars in millions) | |
| Non-performing loans: | | |
| Commercial and industrial | $298 | $252 |
| Commercial real estate mortgage—owner-occupied | 216 | 238 |
| Commercial real estate construction—owner-occupied | 3 | 3 |
| Total commercial | 517 | 493 |
| Commercial investor real estate mortgage | 85 | 123 |
| Commercial investor real estate construction | — | 2 |
| Total investor real estate | 85 | 125 |
| Residential first mortgage | 101 | 109 |
| Home equity | 97 | 102 |
| Total consumer | 198 | 211 |
| Total non-performing loans, excluding loans held for sale | 800 | 829 |
| Non-performing loans held for sale | 32 | 38 |
| Total non-performing loans(1) | 832 | 867 |
| Foreclosed properties | 138 | 124 |
| Total non-performing assets(1) | $970 | $991 |
| Accruing loans 90 days past due: | | |
| Commercial and industrial | $4 | $7 |
| Commercial real estate mortgage—owner-occupied | 7 | 5 |
| Total commercial | 11 | 12 |
| Commercial investor real estate mortgage | 2 | 3 |
| Total investor real estate | 2 | 3 |
| Residential first mortgage(2) | 109 | 122 |
| Home equity | 67 | 63 |
| Indirect | 6 | 7 |
| Consumer credit card | 12 | 12 |
| Other consumer | 4 | 3 |
| Total consumer | 198 | 207 |
| | $211 | $222 |
| Restructured loans not included in the categories above | $1,220 | $1,260 |
| Restructured loans held for sale not included in the categories above | $1 | $1 |
| Non-performing loans(1) to loans and non-performing loans held for sale | 1.06 % | 1.12 % |
| Non-performing assets(1) to loans, foreclosed properties and non-performing loans held for sale | 1.24 % | 1.28 % |

(1) Excludes accruing loans 90 days past due.

(2) Excludes residential first mortgage loans that are 100% guaranteed by the Federal Housing Administration (FHA) and all guaranteed loans sold to the Government National Mortgage Association (GNMA) where Regions has the right but not the obligation to repurchase. Total 90 days or more past due guaranteed loans excluded were $116 million at March 31, 2015 and $125 million at December 31, 2014.

Non-performing assets totaled $970 million at March 31, 2015, compared to $991 million at December 31, 2014. The decrease in non-performing assets during the first three months of 2015 reflects the Company's continuing efforts to work through problem assets and reduce the riskiest exposures.

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Based on current expectations for the economy, management anticipates non-performing assets to continue to improve in 2015 as compared to 2014. Economic trends such as real estate valuations, interest rates, unemployment and volatility in commodity prices will impact the future level of non-performing assets. Circumstances related to individually large credits could also result in volatility throughout 2015.

Loans past due 90 days or more and still accruing, excluding government guaranteed loans, were $211 million at March 31, 2015, a decrease from $222 million at December 31, 2014.

At March 31, 2015, Regions had approximately $125 million to $200 million of potential problem commercial and investor real estate loans that were not included in non-accrual loans, but for which management had concerns as to the ability of such borrowers to comply with their present loan repayment terms. This is a likely estimate of the amount of commercial and investor real estate loans that may migrate to non-accrual status in the next quarter.

In order to arrive at the estimate of potential problem loans, personnel from geographic regions forecast certain larger dollar loans that may potentially be downgraded to non-accrual at a future time, depending on the occurrence of future events. These personnel consider a variety of factors, including the borrower's capacity and willingness to meet the contractual repayment terms, make principal curtailments or provide additional collateral when necessary, and provide current and complete financial information including global cash flows, contingent liabilities and sources of liquidity. Based upon the consideration of these factors, a probability weighting is assigned to loans to reflect the potential for migration to the pool of potential problem loans during this specific time period. Additionally, for other loans (for example, smaller dollar loans), a trend analysis is incorporated to determine the estimate of potential future downgrades. Because of the inherent uncertainty in forecasting future events, the estimate of potential problem loans ultimately represents the estimated aggregate dollar amounts of loans as opposed to an individual listing of loans.

The majority of the loans on which the potential problem loan estimate is based are considered criticized and classified. Detailed disclosures for substandard accrual loans (as well as other credit quality metrics) are included in Note 4 "Loans and the Allowance for Credit Losses" to the consolidated financial statements.

The following table provides an analysis of non-accrual loans (excluding loans held for sale) by portfolio segment:

Table 10—Analysis of Non-Accrual Loans

| | Non-Accrual Loans, Excluding Loans Held for Sale Three Months Ended March 31, 2015 | | | |
|---|---|---|---|---|
| | Commercial | Investor Real Estate | Consumer[1] | Total |
| | (In millions) | | | |
| Balance at beginning of period | $493 | $125 | $211 | $829 |
| Additions | 138 | 8 | (13) | 133 |
| Net payments/other activity | (50) | (14) | — | (64) |
| Return to accrual | (16) | (10) | — | (26) |
| Charge-offs on non-accrual loans[2] | (32) | (8) | — | (40) |
| Transfers to held for sale[3] | (10) | (2) | — | (12) |
| Transfers to foreclosed properties | (4) | (14) | — | (18) |
| Sales | (2) | — | — | (2) |
| Balance at end of period | $517 | $85 | $198 | $800 |

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| | Non-Accrual Loans, Excluding Loans Held for Sale Three Months Ended March 31, 2014 | | | |
|---|---|---|---|---|
| | Commercial | Investor Real Estate | Consumer[1] | Total |
| | (In millions) | | | |
| Balance at beginning of period | $577 | $248 | $257 | $1,082 |
| Additions | 160 | 22 | (5) | 177 |
| Net payments/other activity | (57) | (35) | — | (92) |
| Return to accrual | (22) | (5) | — | (27) |
| Charge-offs on non-accrual loans[2] | (39) | (8) | (1) | (48) |
| Transfers to held for sale[3] | (10) | (4) | (1) | (15) |
| Transfers to foreclosed properties | (6) | (1) | — | (7) |
| Balance at end of period | $603 | $217 | $250 | $1,070 |

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(1) All net activity within the consumer portfolio segment other than sales and transfers to held for sale (including related charge-offs) is included as a single net number within the additions line.

(2) Includes charge-offs on loans on non-accrual status and charge-offs taken upon sale and transfer of non-accrual loans to held for sale.

(3) Transfers to held for sale are shown net of charge-offs of $7 million and $8 million recorded upon transfer for the three months ended March 31, 2015 and 2014, respectively.

ALL OTHER INTEREST-EARNING ASSETS

All other interest-earning assets, which consist of interest-bearing deposits in other banks, federal funds sold and securities purchased under agreements to resell, trading account securities, and other interest-earning assets, increased approximately $1.9 billion from year-end 2014 to March 31, 2015, due to an increase in interest-bearing deposits in other banks as a result of low-cost deposit growth outpacing loan growth.

GOODWILL

Goodwill totaled $4.8 billion at both March 31, 2015 and December 31, 2014 and is allocated to each of Regions' reportable segments (each a reporting unit), at which level goodwill is tested for impairment on an annual basis or more often if events and circumstances indicate the fair value of the reporting unit may have declined below the carrying value (refer to Note 1 "Summary of Significant Accounting Policies" to the 2014 consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2014 for further discussion of when Regions tests goodwill for impairment and the Company's methodology and valuation approaches used to determine the estimated fair value of each reporting unit).

The result of the assessment performed for the first quarter of 2015 did not indicate that the estimated fair values of the Company's reporting units (Corporate Bank, Consumer Bank and Wealth Management) had declined below their respective carrying values; therefore, Regions determined that a test of goodwill impairment was not required for each of Regions' reporting units for the March 31, 2015 interim period.

OTHER ASSETS

Other assets decreased approximately $240 million from December 31, 2014 to $5.8 billion as of March 31, 2015. The decline was due primarily to higher investment security purchases in process at year-end than in the first quarter, as well as a reduction in deferred income taxes.

DEPOSITS

Regions competes with other banking and financial services companies for a share of the deposit market. Regions' ability to compete in the deposit market depends heavily on the pricing of its deposits and how effectively the Company meets customers' needs. Regions employs various means to meet those needs and enhance competitiveness, such as providing a high level of customer service, competitive pricing and providing convenient branch locations for its customers. Regions also serves customers through providing centralized, high-quality banking services and alternative product delivery channels such as internet banking.

The following table summarizes deposits by category:

Table 11—Deposits

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (In millions) | |
| Non-interest-bearing demand | $33,553 | $31,747 |
| Savings | 7,146 | 6,653 |
| Interest-bearing transaction | 21,780 | 21,544 |
| Money market—domestic | 26,371 | 25,396 |
| Money market—foreign | 238 | 265 |
| Low-cost deposits | 89,088 | 85,605 |
| Time deposits | 8,389 | 8,595 |
| | $97,477 | $94,200 |

Total deposits at March 31, 2015 increased approximately $3.3 billion compared to year-end 2014 levels. The growth was primarily driven by consumer deposits with broad based geographic increases in non-interest-bearing demand, savings, interest-bearing transaction and money market—domestic categories. This growth was partially offset by continued declines in time deposits.

SHORT-TERM BORROWINGS

Table 12—Short-Term Borrowings

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (In millions) | |
| Company funding sources: | | |
| Federal Home Loan Bank advances | $— | $500 |
| | | |
| Customer-related borrowings: | | |
| Securities sold under agreements to repurchase | 2,085 | 1,753 |
| | $2,085 | $2,253 |

Company Funding Sources

In the near term, Regions expects the use of wholesale unsecured borrowings, such as Federal funds purchased, to remain low. Short-term secured borrowings, such as securities sold under agreements to repurchase and Federal Home Loan Bank ("FHLB") advances, are a core portion of Regions funding strategy and can fluctuate significantly on a day-to-day basis, depending on funding needs and which sources of funds are used to satisfy those needs.

Regions has taken an approach to maintain higher levels of cash at the Federal Reserve Bank. These higher levels of cash negate the need to occasionally borrow short-term funds to cover normal monthly cash flow needs. The securities financing market and short-term FHLB advances, however, continue to provide reliable funding at attractive rates. See the "Liquidity Risk" section for further detail of Regions' borrowing capacity with the FHLB.

Customer-Related Borrowings

Repurchase agreements are also offered as short-term investment opportunities for commercial banking customers. At the end of each business day, customer balances are swept into the agreement account. Regions Bank does not manage the level of these investments on a daily basis as the transactions are initiated by the customers. The level of these

borrowings can fluctuate significantly on a day-to-day basis.
As a result of Regions' work toward compliance with the new Liquidity Coverage Ratio, repurchase agreement products and balances are in the process of being phased out with the vast majority expected to be gone by the end of the second quarter of

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2015. Customers' balances could remain in interest-bearing transaction or money market deposit accounts going forward. See the "Liquidity Coverage Ratio" discussion within the "Regulatory Requirements" section of Management's Discussion and Analysis for additional information.

LONG-TERM BORROWINGS

Table 13—Long-Term Borrowings

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (In millions) | |
| Regions Financial Corporation (Parent): | | |
| 5.75% senior notes due June 2015 | $500 | $499 |
| 2.00% senior notes due May 2018 | 748 | 748 |
| 7.75% subordinated notes due September 2024 | 100 | 100 |
| 6.75% subordinated debentures due November 2025 | 160 | 160 |
| 7.375% subordinated notes due December 2037 | 300 | 300 |
| Valuation adjustments on hedged long-term debt | (4) | (8) |
| | 1,804 | 1,799 |
| Regions Bank: | | |
| Federal Home Loan Bank advances | 8 | 8 |
| 5.20% subordinated notes due April 2015 | 350 | 350 |
| 7.50% subordinated notes due May 2018 | 500 | 750 |
| 6.45% subordinated notes due June 2037 | 497 | 497 |
| 3.80% affiliate subordinated notes due February 2025 | 150 | — |
| Other long-term debt | 49 | 57 |
| Valuation adjustments on hedged long-term debt | — | 1 |
| | 1,554 | 1,663 |
| Elimination of 3.80% affiliate subordinated notes due February 2025 | (150) | — |
| Total consolidated | $3,208 | $3,462 |

Long-term borrowings decreased approximately $254 million since year-end 2014. On February 12, 2015, Regions Bank launched a tender offer for a portion of its outstanding 7.50% subordinated notes due 2018. Pursuant to the terms and conditions of the tender offer, Regions Bank purchased approximately $250 million aggregate principal amount of the subordinated notes. The tender offer had an early tender premium for subordinated notes tendered by February 26, 2015. Pre-tax losses on early extinguishment related to the full execution of this tender offer were $43 million.

FHLB advances have a weighted-average interest rate of 1.7 percent for both March 31, 2015 and December 31, 2014 with remaining maturities ranging from one to sixteen years.

STOCKHOLDERS’ EQUITY

Stockholders’ equity was $17.1 billion at March 31, 2015 as compared to $16.9 billion at December 31, 2014. During the first quarter of 2015, net income increased stockholders’ equity by $234 million, while cash dividends on common stock reduced equity by $67 million. Changes in accumulated other comprehensive income increased equity by $123 million, primarily due to the net change in the value of securities available for sale and derivative instruments.

During the first quarter of 2015, Regions received no objection from the Federal Reserve to its 2015 capital plan that was submitted as part of the Comprehensive Capital Analysis and Review ("CCAR") process. On April 23, 2015, Regions' Board of Directors approved an increase of its quarterly common stock dividend to $0.06 per share effective with the quarterly dividend to be paid in July 2015, as well as the authorization of a new $875 million common stock repurchase plan, permitting repurchases from the beginning of the second quarter of 2015 through the end of the second quarter of 2016. The Company began purchasing shares pursuant to this plan in April 2015.

As part of its 2014 CCAR submission, Regions' Board of Directors approved an increase to its quarterly common stock dividend from $0.03 per share to $0.05 per share effective with the quarterly dividend paid in July 2014, as well as a $350 million common repurchase plan. The Company closed out this repurchase plan in the first quarter of 2015, repurchasing an additional approximately 11 million shares of common stock at a total cost of approximately $102 million. These shares were immediately retired and therefore are not included in treasury stock.

Regions’ Board of Directors declared a cash dividend for first quarter of 2015 of $0.05 per common share compared to $0.03 per common share for the first quarter of 2014. The Board of Directors also declared $16 million in cash dividends on preferred stock during the first quarter of 2015 compared to $8 million during the first quarter of 2014. The increase in preferred dividends resulted from the issuance of an additional series of preferred stock during the second quarter of 2014. Because the Company was in a retained deficit position, common dividends were recorded as a reduction of additional paid-in capital and preferred dividends were recorded as a reduction of preferred stock, including related surplus.

See Note 7 “Stockholders’ Equity and Accumulated Other Comprehensive Income (Loss)” for additional information.

REGULATORY REQUIREMENTS

CAPITAL RULES

Regions and Regions Bank are required to comply with regulatory capital requirements established by Federal and State banking agencies. These regulatory capital requirements involve quantitative measures of the Company’s assets, liabilities and certain off-balance sheet items, and also qualitative judgments by the regulators. Failure to meet minimum capital requirements can subject the Company to a series of increasingly restrictive regulatory actions. Previously under Basel I, there were two basic measures of capital adequacy: a risk-based measure and a leverage measure.

In July 2013, Regions' and Regions Bank's primary federal regulator, the Federal Reserve, published final rules establishing a new comprehensive capital framework for U.S. banking organizations. The Final Rules implement the Basel Committee on Banking Supervision's (the "Basel Committee") December 2010 framework known as Basel III for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Final Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and the Bank, compared to the previous U.S. risk-based capital rules. The Final Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. The Final Rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the previous risk-weighting approach, which was derived from Basel I, with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee's 2004 Basel II capital accords. The Final Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules. The Final Rules were effective for Regions and Regions Bank on January 1, 2015 (subject to a phase-in period).

The Final Rules, among other things, (i) introduce a measure called Common Equity Tier 1 (“CET1”), (ii) specify that Tier 1 capital consists of CET1 and “Additional Tier 1 capital” instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments to capital as compared to existing regulations.

Under the Final Rules, the initial minimum capital ratios as of January 1, 2015 were as follows:

- 4.5% CET1 to risk-weighted assets.
- 6.0% Tier 1 capital to risk-weighted assets.
- 8.0% Total capital to risk-weighted assets.

The Final Rules also introduce a new capital conservation buffer designed to absorb losses during periods of economic stress. The capital conservation buffer is composed entirely of CET1, on top of these minimum risk-weighted asset ratios. In addition, the Final Rules provide for a countercyclical capital buffer applicable only to certain covered institutions. Currently the countercyclical capital buffer is not applicable to Regions or Regions Bank. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

When fully phased-in on January 1, 2019, the Final Rules will require Regions and Regions Bank to maintain an additional capital conservation buffer of 2.5% of CET1 to risk-weighted assets, effectively resulting in minimum ratios of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5%, and

(iii) Total capital to risk-weighted assets of at least 10.5%.

The Final Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, certain deferred tax assets and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under Basel I, the effects of accumulated other comprehensive income items included in capital were excluded for the purposes of determining regulatory capital ratios. Under the Final Rules, the effects of certain accumulated other comprehensive items are included; however, non-advanced approaches banking organizations, including Regions and Regions Bank, may make a one-time permanent election to continue to exclude these items. Regions and Regions Bank made this election in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of their securities portfolios. The Final Rules also preclude certain hybrid securities, such as trust preferred securities, as

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Tier 1 capital of bank holding companies, subject to phase-out. As of March 31, 2015, Regions did not have any hybrid securities subject to disallowance.

Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased-in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a 4-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

With respect to Regions Bank, the Final Rules also revise the "prompt corrective action" regulations pursuant to Section 38 of the Federal Deposit Insurance Act, by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category, with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the previous 6%); and (iii) eliminating the provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be adequately capitalized. The Final Rules do not change the total risk-based capital requirement for any "prompt corrective action" category.

The Final Rules prescribe a standardized approach for risk weightings that expands the risk-weighting categories from the previous four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Specific changes to Basel I rules impacting Regions' determination of risk-weighted assets include, among other things:

- Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction exposures.
- Assigning a 150% risk weight to exposures (other than secured exposures including residential mortgage exposures) that are 90 days or more past due (previously set at 100%).
- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of less than one year that is not unconditionally cancellable (previously set at 0%).
- Eliminating the previous 50% cap on the risk weight for over-the-counter derivative exposures.
- Replacing the previous Ratings Based Approach for certain asset-backed securities with a Simplified Supervisory Formula Approach ("SSFA") which results in risk weights ranging from 20% to 1,250%.
- Effective January 1, 2018, applying a 250% risk weight to the portion of mortgage servicing rights and deferred tax assets that are includible in capital (previously set at 100%).

In addition, the Final Rules also provide more advantageous risk weights for derivatives and repurchase-style transactions cleared through a qualifying central counterparty and increase the scope of eligible guarantors and eligible collateral for purposes of credit risk mitigation.

Table 14—Regulatory Capital Requirements

| Transitional Basis Basel III Risk-Based Capital Rules | March 31, 2015 Ratio[1] | | To Be Well Capitalized | |
|---|---|---|---|---|
| Basel III common equity Tier 1 ratio: | | | | |
| Regions Financial Corporation | 11.41 | % | 6.50 | % |
| Regions Bank | 12.11 | | 6.50 | % |
| Tier 1 capital: | | | | |
| Regions Financial Corporation | 12.20 | % | 8.00 | % |
| Regions Bank | 12.11 | | 8.00 | |
| Total capital: | | | | |
| Regions Financial Corporation | 14.63 | % | 10.00 | % |
| Regions Bank | 14.22 | | 10.00 | |
| Leverage: | | | | |
| Regions Financial Corporation | 10.64 | % | 5.00 | % |
| Regions Bank | 10.56 | | 5.00 | |

| Basel I Risk-Based Capital Rules | December 31, 2014 Ratio | | To Be Well Capitalized | |
|---|---|---|---|---|
| Tier 1 capital: | | | | |
| Regions Financial Corporation | 12.54 | % | 6.00 | % |
| Regions Bank | 12.30 | | 6.00 | |
| Total capital: | | | | |
| Regions Financial Corporation | 15.26 | % | 10.00 | % |
| Regions Bank | 14.45 | | 10.00 | |
| Leverage[2]: | | | | |
| Regions Financial Corporation | 10.86 | % | 5.00 | % |
| Regions Bank | 10.64 | | 5.00 | |

(1) Current quarter ratios are estimated.

(2) The Leverage ratio requires an additional 100 to 200 basis-point cushion, in certain circumstances, of adjusted quarterly average assets.

Additionally, analysts and banking regulators have assessed Regions’ capital adequacy using tangible common stockholders’ equity. Because tangible common stockholders’ equity is not formally defined by GAAP or prescribed in amount by federal banking regulations, this measure is currently considered to be a non-GAAP financial measure and other entities may calculate it differently than Regions’ disclosed calculation (see Table 16 “GAAP to Non-GAAP Reconciliation” for further details).

LIQUIDITY COVERAGE RATIO ("LCR")

On September 3, 2014, the Federal Reserve Board, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") approved a final rule implementing a minimum liquidity coverage ratio ("LCR") requirement for certain large bank holding companies, savings and loan holding companies and depository institutions, and a less stringent LCR requirement (the "modified LCR") for other banking organizations, such as Regions, with $50 billion or more in total consolidated assets. The final rule imposes a monthly reporting requirement instead of the daily requirement contemplated in the proposed LCR rule. In January 2016, the minimum phased-in LCR requirement will be 90 percent, followed by 100 percent in January 2017. The Company anticipates being fully compliant with the LCR requirements upon implementation without having to make any significant changes to its current balance sheet. However, should the Company's cash position or investment mix change in the future, the Company's ability to meet the LCR requirement may be impacted.

See the “Supervision and Regulation—Capital Requirements” subsection of the “Business” section and the “Risk Factors” section of the Company's Annual Report on Form 10-K for the year ended December 31, 2014 for more information.

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RATINGS

Table 15 “Credit Ratings” reflects the debt ratings information of Regions Financial Corporation and Regions Bank by Standard and Poor's ("S&P"), Moody’s, Fitch and Dominion Bond Rating Service ("DBRS") as of March 31, 2015 and December 31, 2014.

Table 15—Credit Ratings

| | As of March 31, 2015 and December 31, 2014 | | | |
|---|---|---|---|---|
| | S&P | Moody’s | Fitch | DBRS |
| Regions Financial Corporation | | | | |
| Senior notes | BBB | Ba1 | BBB | BBB |
| Subordinated notes | BBB- | Ba2 | BBB- | BBBL |
| Regions Bank | | | | |
| Short-term debt | A-2 | P-3 | F2 | R-1L |
| Long-term bank deposits(1) | N/A | Baa3 | BBB+ | BBBH |
| Long-term debt | BBB+ | Baa3 | BBB | BBBH |
| Subordinated debt | BBB | Ba1 | BBB- | BBB |
| Outlook | Stable | Positive | Stable | Stable |

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(1) S&P does not provide a rating for Long-term bank deposits therefore the rating is N/A.

In general, ratings agencies base their ratings on many quantitative and qualitative factors, including capital adequacy, liquidity, asset quality, business mix, probability of government support, and level and quality of earnings. Any downgrade in credit ratings by one or more ratings agencies may impact Regions in several ways, including, but not limited to, Regions’ access to the capital markets or short-term funding, borrowing cost and capacity, collateral requirements, acceptability of its letters of credit, and funding of variable rate demand notes ("VRDNs"), thereby potentially adversely impacting Regions’ financial condition and liquidity. See the “Risk Factors” section in the Annual Report on Form 10-K for the year ended December 31, 2014 for more information.

A security rating is not a recommendation to buy, sell or hold securities, and the ratings are subject to revision or withdrawal at any time by the assigning rating agency. Each rating should be evaluated independently of any other rating.

NON-GAAP MEASURES

The table below presents computations of earnings and certain other financial measures, which exclude certain significant items that are included in the financial results presented in accordance with GAAP. These non-GAAP financial measures include “adjusted fee income ratio”, “adjusted efficiency ratio”, “return on average tangible common stockholders’ equity”, average and end of period “tangible common stockholders’ equity”, and “Basel III CET1, on a fully phased-in basis” and related ratios. Regions believes that expressing earnings and certain other financial measures excluding these significant items provides a meaningful base for period-to-period comparisons, which management believes will assist investors in analyzing the operating results of the Company and predicting future performance. These non-GAAP financial measures are also used by management to assess the performance of Regions’ business because management does not consider the activities related to the adjustments to be indications of ongoing operations. Regions believes that presentation of these non-GAAP financial measures will permit investors to assess the performance of the Company on the same basis as that applied by management. Management and the Board of Directors utilize these non-GAAP financial measures as follows:

- Preparation of Regions’ operating budgets
- Monthly financial performance reporting
- Monthly close-out reporting of consolidated results (management only)
- Presentations to investors of Company performance

The adjusted efficiency ratio (non-GAAP), which is a measure of productivity, is generally calculated as non-interest expense divided by total revenue on a taxable-equivalent basis. The adjusted fee income ratio (non-GAAP) is generally calculated as non-interest income divided by total revenue on a taxable-equivalent basis. Management uses these ratios to monitor performance and believes these measures provide meaningful information to investors. Non-interest expense (GAAP) is presented excluding adjustments to arrive at adjusted non-interest expense (non-GAAP), which is the numerator for the adjusted efficiency ratio. Non-interest income (GAAP) is presented excluding adjustments to arrive at adjusted non-interest income (non-GAAP), which is the numerator for the adjusted fee income ratio. Net interest income on a taxable-equivalent basis and non-interest income are added together to arrive at total revenue on a taxable-equivalent basis. Adjustments are made to arrive at adjusted total revenue on a taxable-equivalent basis (non-GAAP), which is the denominator for the adjusted efficiency and adjusted fee income ratios.

Tangible common stockholders' equity ratios have become a focus of some investors in analyzing the capital position of the Company absent the effects of intangible assets and preferred stock. Traditionally, the Federal Reserve and other banking regulatory bodies have assessed a bank's capital adequacy based on Tier 1 capital, the calculation of which is codified in federal banking regulations. Analysts and banking regulators have assessed Regions' capital adequacy using the tangible common stockholders' equity measure. Because tangible common stockholders' equity is not formally defined by GAAP, this measure is considered to be non-GAAP financial measures and other entities may calculate it differently than Regions' disclosed calculations. Since analysts and banking regulators may assess Regions' capital adequacy using tangible common stockholders' equity, Regions believes that it is useful to provide investors the ability to assess Regions' capital adequacy on this same basis.

In December 2010, the Basel Committee released its final framework for Basel III, which will strengthen international capital and liquidity regulations. When fully phased-in, Basel III will increase capital requirements through higher minimum capital levels as well as through increases in risk-weights for certain exposures. Additionally, the final Basel III rules place greater emphasis on common equity. In July 2013, the Federal Reserve released final rules detailing the U.S. implementation of Basel III. Regions, as a non-advanced approaches bank, began transitioning to the Basel III framework in January 2015 subject to a phase-in period extending through January 2019. Because the Basel III implementation regulations will not be fully phased-in until 2019 and, are not formally defined by GAAP, these measures are considered to be non-GAAP financial measures. Since analysts and banking regulators may assess Regions' capital adequacy using the fully phased-in Basel III framework, Regions believes that it is useful to provide investors information enabling them to assess Regions' capital adequacy on the same basis.

Non-GAAP financial measures have inherent limitations, are not required to be uniformly applied and are not audited. Although these non-GAAP financial measures are frequently used by stakeholders in the evaluation of a company, they have limitations as analytical tools, and should not be considered in isolation, or as a substitute for analyses of results as reported under GAAP. In particular, a measure of earnings that excludes selected items does not represent the amount that effectively accrues directly to stockholders.

The following tables provide: 1) a reconciliation of net income (GAAP) to net income available to common shareholders (GAAP), 2) a reconciliation of non-interest expense from continuing operations (GAAP) to adjusted non-interest expense (non-GAAP), 3) a reconciliation of non-interest income from continuing operations (GAAP) to adjusted non-interest income (non-GAAP), 4) a computation of adjusted total revenue (non-GAAP), 5) a computation of the adjusted efficiency ratio (non-GAAP), 6) a computation of the adjusted fee income ratio (non-GAAP), 7) a reconciliation of average and ending stockholders' equity (GAAP) to average and ending tangible common stockholders' equity (non-GAAP) and calculations of related ratios (non-GAAP), 8) a reconciliation of stockholders' equity (GAAP) to Basel III CET1, on a fully phased-in basis (non-GAAP), and calculation of the related ratio based on Regions' current understanding of the Basel III requirements.

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Table 16—GAAP to Non-GAAP Reconciliation

| | | Three Months Ended March 31 | |
|---|---|---|---|
| | | 2015 | 2014 |
| | | (Dollars in millions, except per share data) | |
| INCOME (LOSS) | | | |
| Net income (GAAP) | | $234 | $315 |
| Preferred dividends (GAAP) | | (16) | (8) |
| Net income available to common shareholders (GAAP) | A | $218 | $307 |
| ADJUSTED FEE INCOME AND EFFICIENCY RATIOS | | | |
| Non-interest expense from continuing operations (GAAP) | | $905 | $817 |
| Significant items: | | | |
| Branch consolidation and property and equipment charges | | (22) | (6) |
| Gain on sale of TDRs held for sale, net | | — | 35 |
| Loss on early extinguishment of debt | | (43) | — |
| Adjusted non-interest expense (non-GAAP) | B | $840 | $846 |
| Net interest income (GAAP) | | $815 | $816 |
| Taxable-equivalent adjustment | | 17 | 15 |
| Net interest income from continuing operations, taxable-equivalent basis | | 832 | 831 |
| Non-interest income from continuing operations (GAAP) | | 470 | 457 |
| Significant items: | | | |
| Securities gains, net | | (5) | (2) |
| Leveraged lease termination gains, net | | (2) | (1) |
| Adjusted non-interest income (non-GAAP) | C | 463 | 454 |
| Adjusted total revenue, taxable-equivalent basis (non-GAAP) | D | $1,295 | $1,285 |
| Adjusted efficiency ratio (non-GAAP) | B/D | 64.91% | 65.91% |
| Adjusted fee income ratio (non-GAAP) | C/D | 35.75% | 35.26% |
| RETURN ON AVERAGE TANGIBLE COMMON STOCKHOLDERS’ EQUITY | | | |
| Average stockholders’ equity (GAAP) | | $16,963 | $15,892 |
| Less: Average intangible assets (GAAP) | | 5,089 | 5,107 |
| Average deferred tax liability related to intangibles (GAAP) | | (172) | (187) |
| Average preferred stock (GAAP) | | 878 | 444 |
| Average tangible common stockholders’ equity (non-GAAP) | E | $11,168 | $10,528 |
| Return on average tangible common stockholders’ equity (non-GAAP)(1) | A/E | 7.91% | 11.80% |

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| | | March 31, 2015 | December 31, 2014 |
|---|---|---|---|
| | | (Dollars in millions, except per share data) | |
| TANGIBLE COMMON RATIOS | | | |
| Ending stockholders' equity (GAAP) | | $17,051 | $16,873 |
| Less: Ending intangible assets (GAAP) | | 5,088 | 5,091 |
| Ending deferred tax liability related to intangibles (GAAP) | | (173) | (172) |
| Ending preferred stock (GAAP) | | 868 | 884 |
| Ending tangible common stockholders' equity (non-GAAP) | F | $11,268 | $11,070 |
| Ending total assets (GAAP) | | $122,447 | $119,563 |
| Less: Ending intangible assets (GAAP) | | 5,088 | 5,091 |
| Ending deferred tax liability related to intangibles (GAAP) | | (173) | (172) |
| Ending tangible assets (non-GAAP) | G | $117,532 | $114,644 |
| End of period shares outstanding | H | 1,343 | 1,354 |
| Tangible common stockholders' equity to tangible assets (non-GAAP) | F/G | 9.59% | 9.66% |
| Tangible common book value per share (non-GAAP) | F/H | $8.39 | $8.18 |
| BASEL III COMMON EQUITY TIER 1 RATIO-FULLY PHASED-IN PRO-FORMA(2) | | | |
| Stockholders' equity (GAAP) | | $17,051 | |
| Non-qualifying goodwill and intangibles | | (4,910) | |
| Adjustments, including all components of accumulated other comprehensive income, disallowed deferred tax assets, threshold deductions and other adjustments | | 1 | |
| Preferred stock (GAAP) | | (868) | |
| Basel III common equity Tier 1 (non-GAAP) | I | $11,274 | |
| Basel III risk-weighted assets (non-GAAP)(3) | J | $101,027 | |
| Basel III common equity Tier 1 ratio (non-GAAP) | I/J | 11.16% | |

(1) Income statement amounts have been annualized in calculation.

(2) Current quarter amounts and the resulting ratio are estimated. Regulatory capital measures for periods prior to the first quarter of 2015 have not been revised to reflect the retrospective application of new accounting guidance related to investments in qualified affordable housing projects. As a result, prior period measures and calculations are not presented in the table.

(3) Regions continues to develop systems and internal controls to precisely calculate risk-weighted assets as required by Basel III on a fully phased-in basis. The amount included above is a reasonable approximation, based on our understanding of the requirements.

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NET INTEREST INCOME AND MARGIN

Table 17—Consolidated Average Daily Balances and Yield/Rate Analysis for Continuing Operations

| | Three Months Ended March 31 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2015 | | | | 2014 | | | |
| | Average Balance | Income/ Expense | Yield/ Rate | | Average Balance | Income/ Expense | Yield/ Rate | |
| | (Dollars in millions; yields on taxable-equivalent basis) | | | | | | | |
| Assets | | | | | | | | |
| Interest-earning assets: | | | | | | | | |
| Federal funds sold and securities purchased under agreements to resell | $21 | $— | 0.82 | % | $9 | $— | 0.86 | % |
| Trading account securities | 104 | 3 | 12.91 | | 111 | 2 | 6.31 | |
| Securities: | | | | | | | | |
| Taxable | 24,682 | 153 | 2.51 | | 23,872 | 154 | 2.62 | |
| Tax-exempt | 2 | — | — | | 4 | — | — | |
| Loans held for sale | 406 | 3 | 3.46 | | 854 | 8 | 3.89 | |
| Loans, net of unearned income(1)(2) | 77,942 | 742 | 3.86 | | 75,139 | 747 | 4.03 | |
| Other interest-earning assets | 2,974 | 2 | 0.28 | | 3,490 | 2 | 0.28 | |
| Total interest-earning assets | 106,131 | 903 | 3.45 | | 103,479 | 913 | 3.58 | |
| Allowance for loan losses | (1,098) | | | | (1,321) | | | |
| Cash and due from banks | 1,773 | | | | 1,817 | | | |
| Other non-earning assets | 13,760 | | | | 13,742 | | | |
| | $120,566 | | | | $117,717 | | | |
| Liabilities and Stockholders' Equity | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | |
| Savings | $6,878 | 2 | 0.14 | | $6,434 | 2 | 0.12 | |
| Interest-bearing checking | 21,769 | 5 | 0.09 | | 20,791 | 5 | 0.09 | |
| Money market | 26,381 | 7 | 0.11 | | 26,013 | 8 | 0.13 | |
| Time deposits | 8,500 | 14 | 0.65 | | 9,419 | 12 | 0.53 | |
| Total interest-bearing deposits(3) | 63,528 | 28 | 0.18 | | 62,657 | 27 | 0.17 | |
| Federal funds purchased and securities sold under agreements to repurchase | 1,685 | — | 0.05 | | 2,097 | — | 0.08 | |
| Other short-term borrowings | 161 | — | 0.19 | | — | — | — | |
| Long-term borrowings | 3,371 | 43 | 5.20 | | 4,643 | 55 | 4.78 | |
| Total interest-bearing liabilities | 68,745 | 71 | 0.42 | | 69,397 | 82 | 0.48 | |
| Non-interest-bearing deposits(3) | 32,255 | — | — | | 30,268 | — | — | |
| Total funding sources | 101,000 | 71 | 0.29 | | 99,665 | 82 | 0.33 | |
| Net interest spread | | | 3.03 | | | | 3.10 | |
| Other liabilities | 2,603 | | | | 2,162 | | | |
| Stockholders' equity | 16,963 | | | | 15,890 | | | |
| | $120,566 | | | | $117,717 | | | |
| Net interest income/margin on a taxable-equivalent basis from continuing operations(4) | | $832 | 3.18 | % | | $831 | 3.26 | % |

(1) Loans, net of unearned income include non-accrual loans for all periods presented.

(2) Interest income includes net loan fees of $17 million and $21 million for the three months ended March 31, 2015 and 2014, respectively.

(3) Total deposit costs may be calculated by dividing total interest expense on deposits by the sum of interest-bearing deposits and non-interest-bearing deposits. The rates for total deposit costs equal 0.12% for both of the three months ended March 31, 2015 and 2014.

(4) The computation of taxable-equivalent net interest income is based on the statutory federal income tax rate of 35%, adjusted for applicable state income taxes net of the related federal tax benefit.

Taxable-equivalent net interest income increased $1 million in the first quarter of 2015 compared to the first quarter of 2014 primarily due to a decline in both the volume of and rates paid on interest-bearing liabilities. These declines were partially offset by a similar decline in interest income earned on approximately $2.7 billion of increased interest-earning assets originated at lower interest rates. The net interest margin (taxable-equivalent basis) declined 8 basis points to 3.18 percent during this same period primarily due to a larger decline in the yield on earning assets than the rates paid on interest-bearing liabilities. Despite the continued

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improvements in both cost and mix of interest-bearing liabilities and the continued increase in interest-earning assets, the net interest income and margin continue to be pressured by a sustained low interest rate environment.

Management is optimistic for continued economic growth in 2015. If economic conditions and interest rates follow a course of moderate increase through 2015, and the Company achieves its targeted range of loan growth, management believes that the net interest margin will remain stable to moderately rising. Alternatively, if rates in 2015 remain at levels prevalent at year-end 2014, management believes the net interest margin will come under modest pressure of approximately 10 basis points over the remainder of the year. Regions' balance sheet is in a moderately asset sensitive position and should benefit from a rise in either long-term or short-term rates. So, if economic conditions were to improve more rapidly, thereby spurring a more rapid rise in interest rates, both net interest income and the resulting net interest margin would respond favorably.

MARKET RISK—INTEREST RATE RISK

Regions' primary market risk is interest rate risk, including uncertainty with respect to absolute interest rate levels as well as uncertainty with respect to relative interest rate levels, which is impacted by both the shape and the slope of the various yield curves that affect the financial products and services that the Company offers. To quantify this risk, Regions measures the change in its net interest income in various interest rate scenarios compared to a base case scenario. Net interest income sensitivity is a useful short-term indicator of Regions' interest rate risk.

Sensitivity Measurement—Financial simulation models are Regions' primary tools used to measure interest rate exposure. Using a wide range of sophisticated simulation techniques provides management with extensive information on the potential impact to net interest income caused by changes in interest rates. Models are structured to simulate cash flows and accrual characteristics of Regions' balance sheet. Assumptions are made about the direction and volatility of interest rates, the slope of the yield curve, and the changing composition of the balance sheet that result from both strategic plans and from customer behavior. Among the assumptions are expectations of balance sheet growth and composition, the pricing and maturity characteristics of existing business and the characteristics of future business. Interest rate-related risks are expressly considered, such as pricing spreads, the pricing of deposit accounts, prepayments and other option risks. Regions considers these factors, as well as the degree of certainty or uncertainty surrounding their future behavior.

The primary objective of asset/liability management at Regions is to coordinate balance sheet composition with interest rate risk management to sustain a reasonable and stable net interest income throughout various interest rate cycles. In computing interest rate sensitivity for measurement, Regions compares a set of alternative interest rate scenarios to the results of a base case scenario based on "market forward rates." The standard set of interest rate scenarios includes the traditional instantaneous parallel rate shifts of plus 100 and 200 basis points. Regions also prepares a minus 50 basis points scenario, as minus 100 and 200 basis scenarios are of limited use in the current rate environment. Up-rate scenarios of greater magnitude are also analyzed, and are of increased importance as the current and historic low levels of interest rates increase the relative likelihood of a rapid and substantial increase in interest rates. Regions also includes simulations of gradual interest rate movements that may more realistically mimic potential interest rate movements. These gradual scenarios include curve steepening, flattening, and parallel movements of various magnitudes phased in over a six-month period, and include rate shifts of minus 50 basis points and plus 100 and 200 basis points.

Exposure to Interest Rate Movements—As of March 31, 2015, Regions was moderately asset sensitive to both gradual and instantaneous parallel yield curve shifts as compared to the base case for the measurement horizon ending March 2016. The estimated exposure associated with the parallel yield curve shift of minus 50 basis points in the table below reflects the combined impacts of movements in short-term and long-term rates. Long-term interest rate reductions will drive yields lower on certain fixed rate loans newly originated or renewed, prospective yields lower on certain investment portfolio purchases, as well as higher amortization of premium on existing securities in the investment portfolio. The decline in short-term interest rates (such as the Fed Funds rate and the rate of Interest on Excess Reserves) will lead to a reduction of yield on assets and liabilities contractually tied to such rates, but since rates have been at low levels for such an extended period, it is expected that declines in deposit costs will only partially offset the decline in asset yields.

Long-term interest rates in early 2015 have recently remained lower than the prevailing levels over the majority of 2014. Short-term rates have remained stable. As described above, with respect to sensitivity to long-term rates, the balance sheet is estimated to be moderately asset sensitive. Current simulation models estimate that, as compared to the base case, net interest income over a 12 month horizon would respond favorably by approximately $112 million if long-term rates were to immediately and on a sustained basis exceed the base scenario by 100 basis points. Conversely, if long-term rates were to immediately and on a sustained basis underperform the base case by 50 basis points, then net interest income, as compared to the base case, would decline by approximately $69 million.

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The table below summarizes Regions' positioning in various parallel yield curve shifts. The scenarios are inclusive of all interest rate risk hedging activities.

Table 18—Interest Rate Sensitivity

| | Estimated Annual Change in Net Interest Income March 31, 2015 (In millions) |
|---|---|
| Gradual Change in Interest Rates | |
| + 200 basis points | $228 |
| + 100 basis points | 126 |
| - 50 basis points | (88) |
| | |
| Instantaneous Change in Interest Rates | |
| + 200 basis points | $272 |
| + 100 basis points | 164 |
| - 50 basis points | (121) |

As discussed above, the interest rate sensitivity analysis presented in Table 18 is informed by a variety of assumptions and estimates regarding the course of the balance sheet in both the baseline scenario as well as the scenarios of instantaneous and gradual shifts in the yield curve. Though there are many assumptions which affect the estimates for net interest income, those pertaining to deposit pricing, deposit mix and overall balance sheet composition are particularly impactful. Given the uncertainties associated with the prolonged period of low interest rates, management evaluates the impact to its sensitivity analysis of these key assumptions.

The Company's baseline balance sheet growth assumptions include continued moderate loan and deposit growth with a composition largely reflecting a continuation of recent trends. The behavior of deposits in response to changes in interest rate levels is largely informed by analyses of prior rate cycles, but with suitable adjustments based on management's expectations in the current rate environment. In the + 200 basis point gradual interest rate change scenario in Table 18, the total cumulative interest bearing deposit re-pricing sensitivity is expected to be approximately 60 percent of changes in short-term market rates (e.g. Federal Funds), as compared to approximately 55 percent in the 2004 to 2007 historical timeframe. A 5 percentage point higher sensitivity than the 60 percent baseline would reduce 12 month net interest income in the gradual +200 basis points scenario by approximately $53 million. Similarly, management assumes that the change in the mix of deposits in a rising rate environment versus the baseline balance sheet growth assumptions is informed by analyses of prior rate cycles. Management assumes that in rising rate scenarios, some shift from non-interest bearing to interest-bearing products will occur. The magnitude of the shift is rate dependent, but equates to approximately $3.5 billion over 12 months in the gradual +200 basis point scenario in Table 18. In the event this shift increased by an additional $3.0 billion over 12 months, the result would be a reduction of 12 month net interest income in the gradual +200 basis points scenario by approximately $24 million. Sensitivity calculations are hypothetical and should not be considered to be predictive of future results.

Interest rate movements may also have an impact on the value of Regions' securities portfolio, which can directly impact the carrying value of stockholders' equity. Regions from time to time may hedge these price movements with derivatives (as discussed below).

Derivatives—Regions uses financial derivative instruments for management of interest rate sensitivity. The Asset and Liability Committee ("ALCO"), which consists of members of Regions' senior management team, in its oversight role for the management of interest rate sensitivity, approves the use of derivatives in balance sheet hedging strategies. The most common derivatives Regions employs are forward rate contracts, Eurodollar futures contracts, interest rate swaps, options on interest rate swaps, interest rate caps and floors, and forward sale commitments. Derivatives are also used to offset the risks associated with customer derivatives, which include interest rate, credit and foreign exchange risks.

Forward rate contracts are commitments to buy or sell financial instruments at a future date at a specified price or yield. A Eurodollar futures contract is a future on a Eurodollar deposit. Eurodollar futures contracts subject Regions to market risk associated with changes in interest rates. Because futures contracts are cash settled daily, there is minimal credit risk associated with Eurodollar futures. Interest rate swaps are contractual agreements typically entered into to exchange fixed for variable (or vice versa) streams of interest payments. The notional principal is not exchanged but is used as a reference for the size of interest settlements. Interest rate options are contracts that allow the buyer to purchase or sell a financial instrument at a predetermined price and time. Forward sale commitments are contractual obligations to sell market instruments at a future date for an already agreed-upon price. Foreign currency contracts involve the exchange of one currency for another on a specified date and at a specified rate. These contracts are executed on behalf of the Company's customers and are used to manage fluctuations in foreign exchange rates. The Company is subject to the credit risk that another party will fail to perform.

Regions has made use of interest rate swaps to effectively convert a portion of its fixed-rate funding position and available for sale securities portfolios to a variable-rate position and, in some cases, to effectively convert a portion of its variable-rate loan portfolios to fixed-rate. Regions also uses derivatives to manage interest rate and pricing risk associated with its mortgage origination business. In the period of time that elapses between the origination and sale of mortgage loans, changes in interest rates have the potential to cause a decline in the value of the loans in this held-for-sale portfolio. Futures contracts and forward sale commitments are used to protect the value of the loan pipeline and loans held for sale from changes in interest rates and pricing.

The following table presents additional information about the interest rate derivatives used by Regions to manage interest rate risk:

Table 19—Hedging Derivatives by Interest Rate Risk Management Strategy

| | March 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | | Estimated Fair Value | | Weighted Average | | |
| | Notional Amount | Gain | Loss | Maturity (Years) | Receive Rate | Pay Rate |
| | (Dollars in millions) | | | | | |
| Interest rate swaps: | | | | | | |
| Derivatives in fair value hedging relationships: | | | | | | |
| Receive fixed/pay variable | $1,684 | $13 | $— | 1.7 | 1.1 % | 0.2 % |
| Receive variable/pay fix | 726 | — | 47 | 10.8 | 0.2 | 2.6 |
| Derivatives in cash flow hedging relationships: | | | | | | |
| Receive fixed/pay variable | 8,950 | 84 | 6 | 3.3 | 1.2 | 0.2 |
| Total derivatives designated as hedging instruments | $11,360 | $97 | $53 | 3.5 | 1.1 % | 0.4 % |

Regions manages the credit risk of these instruments in much the same way as it manages credit risk of the loan portfolios by establishing credit limits for each counterparty and through collateral agreements for dealer transactions. For non-dealer transactions, the need for collateral is evaluated on an individual transaction basis and is primarily dependent on the financial strength of the counterparty. Credit risk is also reduced significantly by entering into legally enforceable master netting agreements. When there is more than one transaction with a counterparty and there is a legally enforceable master netting agreement in place, the exposure represents the net of the gain and loss positions with and collateral received from and/or posted to that counterparty. The majority of interest rate derivatives traded by Regions are subject to mandatory clearing. The counterparty risk for cleared trades effectively moves from the executing broker to the clearinghouse allowing Regions to benefit from the risk mitigation controls in place at the respective clearinghouse. The “Credit Risk” section in Regions’ Annual Report on Form 10-K for the year ended December 31, 2014 contains more information on the management of credit risk.

Regions also uses derivatives to meet the needs of its customers. Interest rate swaps, interest rate options and foreign exchange forwards are the most common derivatives sold to customers. Other derivatives instruments with similar characteristics are used to hedge market risk and minimize volatility associated with this portfolio. Instruments used to service customers are held in the trading account, with changes in value recorded in the consolidated statements of income.

The primary objective of Regions’ hedging strategies is to mitigate the impact of interest rate changes, from an economic perspective, on net interest income and the net present value of its balance sheet. The overall effectiveness of these hedging strategies is subject to market conditions, the quality of Regions’ execution, the accuracy of its valuation assumptions, counterparty credit risk and changes in interest rates. See Note 11 “Derivative Financial Instruments and Hedging Activities” to the consolidated financial statements for a tabular summary of Regions’ quarter-end derivatives positions and further discussion.

Regions accounts for residential mortgage servicing rights at fair market value with any changes to fair value being recorded within mortgage income. Regions enters into derivative and balance sheet transactions to mitigate the impact of market value fluctuations related to residential mortgage servicing rights. Derivative instruments entered into in the future could be materially different from the current risk profile of Regions' current portfolio.

MARKET RISK—PREPAYMENT RISK

Regions, like most financial institutions, is subject to changing prepayment speeds on mortgage-related assets under different interest rate environments. Prepayment risk is a significant risk to earnings and specifically to net interest income. For example, mortgage loans and other financial assets may be prepaid by a debtor, so that the debtor may refinance its obligations at lower rates. As loans and other financial assets prepay in a falling rate environment, Regions must reinvest these funds in lower-yielding assets. Prepayments of assets carrying higher rates reduce Regions' interest income and overall asset yields. Conversely, in a rising rate environment, these assets will prepay at a slower rate, resulting in opportunity cost by not having the cash flow to reinvest at higher rates. Prepayment risk can also impact the value of securities and the carrying value of equity. Regions' greatest exposures to prepayment risks primarily rest in its mortgage-backed securities portfolio, the mortgage fixed-rate loan portfolio and the residential mortgage servicing asset, all of which tend to be sensitive to interest rate movements. Each of these assets is also exposed to prepayment risk due to factors which are not necessarily the result of interest rates, but rather due to changes in policies or programs related, either directly or indirectly, to the U.S. Government's governance over certain lending and financing within the mortgage market. Such policies can work to either encourage or discourage financing dynamics and represent a risk that is extremely difficult to forecast and may be the result of non-economic factors. The Company attempts to monitor and manage such exposures within reasonable expectations while acknowledging all such risks cannot be foreseen or avoided. Further, Regions has prepayment risk that would be reflected in non-interest income in the form of servicing income on loans sold. Regions actively monitors prepayment exposure as part of its overall net interest income forecasting and interest rate risk management. In particular, because current interest rates are relatively low, Regions is actively managing exposure to declining prepayments that are expected to coincide with increasing interest rates in both the loan and securities portfolio.

LIQUIDITY RISK

Liquidity is an important factor in the financial condition of Regions and affects Regions' ability to meet the borrowing needs and deposit withdrawal requirements of its customers. On September 3, 2014, the Federal Reserve Board, the OCC and the FDIC released the final version of the Liquidity Coverage Ratio. The rule is designed to ensure that financial institutions have the necessary assets on hand to withstand short-term liquidity disruptions. See the "Liquidity Coverage Ratio" discussion included in the "Regulatory Capital Requirements" section of Management's Discussion and Analysis for additional information.

Regions intends to fund its obligations primarily through cash generated from normal operations. In addition to these obligations, Regions has obligations related to potential litigation contingencies. See Note 14 "Commitments, Contingencies and Guarantees" to the consolidated financial statements for additional discussion of the Company's funding requirements.

Assets, consisting principally of loans and securities, are funded by customer deposits, purchased funds, borrowed funds and stockholders' equity. Regions' goal in liquidity management is to satisfy the cash flow requirements of depositors and borrowers, while at the same time meeting the Company's cash flow needs. The challenges of the recent recession and the recovery in the current market environment demonstrate the importance of having and using various sources of liquidity to satisfy the Company's funding requirements.

In order to ensure an appropriate level of liquidity is maintained, Regions performs specific procedures including scenario analyses and stress testing at the bank, holding company, and affiliate levels. Regions' liquidity policy requires the holding company to maintain cash sufficient to cover the greater of (1) 18 months of debt service and other cash needs or (2) a minimum cash balance of $500 million. Compliance with the holding company cash requirements is reported to the Risk Committee of the Board of Directors on a quarterly basis. Regions has minimum liquidity requirements for the Bank and subsidiaries. The Bank's funding and contingency planning does not currently include any reliance on short-term unsecured sources. Risk limits are established within the Company's ALCO, which regularly reviews compliance with the established limits.

The securities portfolio is one of Regions' primary sources of liquidity. Proceeds from maturities and principal and interest payments of securities provide a constant flow of funds available for cash needs (see Note 3 "Securities" to the consolidated financial statements). The agency guaranteed mortgage portfolio is another source of liquidity in various

secured borrowing capacities.
Maturities in the loan portfolio also provide a steady flow of funds. Additional funds are provided from payments on consumer loans and one-to-four family residential first mortgage loans. In addition, liquidity needs can also be met by borrowing funds in state and national money markets, although Regions does not currently rely on short-term unsecured wholesale market funding. Regions’ liquidity has been further enhanced by its relatively stable customer deposit base.
The balance with the Federal Reserve Bank is the primary component of the balance sheet line item, “interest-bearing deposits in other banks.” At March 31, 2015, Regions had approximately $4.2 billion in cash on deposit with the Federal Reserve, up from approximately $2.3 billion at December 31, 2014 primarily due to strong deposit growth in the first quarter.
Regions’ borrowing availability with the Federal Reserve Bank as of March 31, 2015, based on assets pledged as collateral on that date, was $21.5 billion.
Regions’ financing arrangement with the FHLB adds additional flexibility in managing the Company's liquidity position. As of March 31, 2015, Regions’ borrowing availability from the FHLB totaled $10.0 billion. FHLB borrowing capacity is contingent

on the amount of collateral pledged to the FHLB. Regions Bank pledged certain residential first mortgage loans on one-to-four family dwellings and home equity lines of credit as collateral for the FHLB advances outstanding. Additionally, investment in FHLB stock is required in relation to the level of outstanding borrowings. Refer to Note 3 "Securities" to the consolidated financial statements for additional information regarding these investments. The FHLB has been and is expected to continue to be a reliable and economical source of funding.

Regions maintains a shelf registration statement with the U.S. Securities and Exchange Commission that can be utilized by Regions to issue various debt and/or equity securities. Regions also maintains a Bank Note program that allows Regions Bank to issue up to $5 billion aggregate principal amount of bank notes outstanding at any one time. Refer to Note 12 "Long-Term Borrowings" to the consolidated financial statements in the 2014 Annual Report on Form 10-K for additional information.

Regions may, from time to time, consider opportunistically retiring outstanding issued securities, including subordinated debt in privately negotiated or open market transactions for cash or common shares. Regulatory approval would be required for retirement of some instruments.

CREDIT RISK

Regions’ objective regarding credit risk is to maintain a high-quality credit portfolio that provides for stable credit costs with acceptable volatility through an economic cycle. Regions has a diversified loan portfolio in terms of product type, collateral and geography. See Table 2 for further details of each loan portfolio segment. See the “Portfolio Characteristics” and “Credit Risk” sections of the Annual Report on Form 10-K for the year ended December 31, 2014 for a discussion of risk characteristics of each loan type.

INFORMATION SECURITY RISK

Operational risks comprise several elements, including information security risks. Information security risks such as evolving and adaptive cyber attacks, for large financial institutions such as Regions have generally increased in recent years and will continue to increase in part because of the proliferation of new technologies, the use of mobile devices, the internet, and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists, nation-states, activists and other external parties or fraud on the part of employees. Regions spends significant resources on operational and information security. Regions is a member of the Financial Services Information Sharing and Analysis Center ("FS-ISAC"). The FS-ISAC is a nonprofit organization and is funded entirely by its member firms and sponsors. The overall objective of FS-ISAC is to protect the financial services sector against cyber and physical threats and risk. It acts as a trusted third party that provides anonymity to allow members to submit threat, vulnerability and incident information in a non-attributable and trusted manner so information that would normally not be shared is instead provided for the good of the membership. In addition to FS-ISAC, Regions is a member of BITS, the technology arm of the Financial Services Roundtable. BITS serves the financial community and its members by providing industry best practices on a variety of security and fraud topics. Regions also maintains a close working relationship with its regulators and law enforcement partners to keep them updated on pertinent risks.

Denial of service attacks, hacking or terrorist activities could disrupt the Company or the Company's customers' or other third parties' business operations. When attacks occur, Regions engages employees from all business groups, not just information technology, to combat these attacks.

Even if Regions successfully prevents data breaches to its own networks, the Company may still incur losses that result from customers' account information obtained through breaches of retailers' networks where customers have transacted business. The fraud losses, as well as the costs of investigations and re-issuing new customer cards impact Regions' financial results.

Regions will continue to commit the resources necessary to mitigate these growing risks, as well as continue to develop and enhance controls, processes and systems to protect our networks, computers, and data from attacks or unauthorized access. In addition, Regions has contracts with vendors to provide denial of service mitigation and these vendors have also continued to commit the necessary resources to support Regions in the event of an attack. Even though Regions devotes significant resources to combat cyber security risks, there is no guarantee that these measures will provide absolute security.

PROVISION FOR LOAN LOSSES

The provision for loan losses is used to maintain the allowance for loan losses at a level that in management’s judgment is appropriate to absorb probable losses inherent in the portfolio at the balance sheet date. The provision for loan losses totaled $49 million in the first quarter of 2015 compared to $2 million during the first quarter of 2014. Refer to the “Allowance for Credit Losses” section of Management's Discussion and Analysis for further detail.

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NON-INTEREST INCOME

Table 20—Non-Interest Income from Continuing Operations

| | Three Months Ended March 31 | | Change March 31, 2015 vs. March 31, 2014 | |
|---|---|---|---|---|
| | 2015 | 2014 | Amount | Percent |
| | (Dollars in millions) | | | |
| Service charges on deposit accounts | $161 | $173 | $(12) | (6.9)% |
| Card and ATM fees | 85 | 79 | 6 | 7.6% |
| Investment management and trust fee income | 51 | 49 | 2 | 4.1% |
| Mortgage income | 40 | 40 | — | —% |
| Insurance commissions and fees | 35 | 30 | 5 | 16.7% |
| Bank-owned life insurance | 20 | 19 | 1 | 5.3% |
| Capital markets fee income and other | 20 | 13 | 7 | 53.8% |
| Commercial credit fee income | 16 | 15 | 1 | 6.7% |
| Investment services fee income | 12 | 10 | 2 | 20.0% |
| Securities gains, net | 5 | 2 | 3 | 150.0% |
| Net revenue from affordable housing | 2 | 1 | 1 | 100.0% |
| Other miscellaneous income | 23 | 26 | (3) | (11.5)% |
| | $470 | $457 | $13 | 2.8% |

Service charges on deposit accounts—Service charges on deposit accounts include non-sufficient fund fees and other service charges. The decrease during the first quarter of 2015 compared to the prior year was primarily due to continued changes in customer behavior, as well as a $9 million reduction of fees resulting from a product discontinuation that concluded in the fourth quarter of 2014.

Card and ATM fees—Card and ATM fees include the combined amounts of credit card/bank card income and debit card and ATM related revenue. The increase in the first quarter of 2015 compared to 2014 was a result of increased checking accounts, as well as increased transactions driven in part by the continued migration of transactions from cash and checks to cards. Additionally, an increase in active credit cards generated greater purchase activity resulting in higher interchange income.

Insurance commissions and fees—Regions sells property and casualty, life and health, mortgage, and other specialty insurance and credit related products to businesses and individuals. The increase in the current period was primarily due to the incremental impact of insurance agency lift outs, combined with organic growth in the insurance agency business.

Capital markets fee income and other—Capital markets fee income and other primarily relates to activities such as securities underwriting and placement, loan syndications, foreign exchange and customer derivatives. The increase in the first quarter of 2015 compared to 2014 was primarily due to higher broker-dealer volume.

Net revenue from affordable housing—Beginning in 2015, Regions adopted new accounting guidance that allows companies with qualified affordable housing tax credit investments to apply a proportional amortization method that recognizes the amortized cost of the investment as a component of income tax expense. The guidance requires retrospective application to all prior periods presented. Actual gains or losses resulting from the sale of these investments, cash distributions from the investments and any future impairment represent the only transactions that will continue to be reflected in this line item. Refer to Note 1 "Basis of Presentation" for additional information.

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NON-INTEREST EXPENSE

Table 21—Non-Interest Expense from Continuing Operations

| | Three Months Ended March 31 | | Change March 31, 2015 vs. March 31, 2014 | |
|---|---|---|---|---|
| | 2015 | 2014 | Amount | Percent |
| | (Dollars in millions) | | | |
| Salaries and employee benefits | $458 | $455 | $3 | 0.7 % |
| Net occupancy expense | 91 | 93 | (2) | (2.2)% |
| Furniture and equipment expense | 71 | 70 | 1 | 1.4 % |
| Professional, legal and regulatory expenses | 19 | 35 | (16) | (45.7)% |
| Outside services | 31 | 27 | 4 | 14.8 % |
| Marketing | 26 | 24 | 2 | 8.3 % |
| Deposit administrative fee | 22 | 22 | — | — % |
| Branch consolidation, property and equipment charges | 22 | 6 | 16 | 266.7 % |
| Loss on early extinguishment of debt | 43 | — | 43 | — % |
| Gain on sale of TDRs held for sale, net | — | (35) | 35 | (100.0)% |
| Other miscellaneous expenses | 122 | 120 | 2 | 1.7 % |
| | $905 | $817 | $88 | 10.8 % |

Salaries and employee benefits—Salaries and employee benefits are comprised of salaries, incentive compensation, long-term incentives, payroll taxes, and other employee benefits such as 401(k), pension, and medical, life and disability insurance, as well as, expenses from liabilities held for employee benefit purposes. Salaries and employee benefits increased slightly during the first quarter of 2015 when compared to the same period of 2014 primarily due to increases in base salaries reflecting the second quarter of 2014 merit increases, as well as, higher pension and health insurance expenses. These increases were partially offset by lower incentive expense. Headcount decreased from 23,687 at March 31, 2014 to 23,601 at March 31, 2015.

Professional, legal and regulatory expenses—Professional, legal and regulatory expenses consist of amounts related to legal, consulting, other professional fees and regulatory charges. These expenses decreased for the first quarter of 2015 when compared to the first quarter of 2014, primarily due to lower legal fees resulting from a declining case load and lower consulting expenses.

Outside services—Outside services consists of expenses related to routine services provided by third parties, such as contract labor, servicing costs, data processing, loan pricing and research, data license purchases, data subscriptions, and check printing. Outside services increased during the first quarter of 2015 when compared to the first quarter of 2014. The increases were primarily due to the use of temporary staffing for compliance and regulatory related projects as well as increased servicing costs related to continued purchases of indirect loans from a third party.

Branch consolidation, property and equipment charges—Regions made the decision to close 50 branches in the fourth quarter of 2014. Valuation adjustments related to owned branches were immediately recorded in the fourth quarter of 2014. Accelerated depreciation and lease write-off charges are recorded through and at the actual branch close date. In the first quarter of 2015, the Company incurred approximately $13 million of related charges. An additional $9 million was recorded during the first quarter of 2015 related to other occupancy optimization efforts.

Loss on early extinguishment of debt—During the first quarter of 2015, the Company incurred an early extinguishment charge related to the execution of a tender offer for approximately $250 million of its 7.50 percent subordinated notes at Regions Bank. There were no debt extinguishments in 2014.

Gain on sale of TDRs held for sale, net—During the fourth quarter of 2013, Regions transferred approximately $535 million of certain primarily accruing residential first mortgage loans classified as TDRs to loans held for sale. During the first quarter of 2014, substantially all of these loans were sold resulting in a $35 million net gain.

INCOME TAXES

The Company’s income tax expense from continuing operations for the three months ended March 31, 2015 was $95 million compared to income tax expense of $151 million for the same period in 2014, resulting in effective tax rates of 28.7 percent and 33.3 percent, respectively. The effective tax rate is lower in the current period as compared to the prior comparable period principally due to an income tax benefit of approximately $10 million related to net state deferred tax assets and the discrete impact of extinguishment charges incurred related to the redemption of certain subordinated notes. The state deferred tax benefit relates to an improved methodology implemented during the current period to estimate the effective state income tax rate.

The Company’s effective tax rate is affected by recurring items such as amortization related to its investments in affordable housing investments net of affordable housing tax credits and other tax benefits, bank-owned life insurance and tax-exempt income. The effective tax rate is also affected by items that may occur in any given period but are not consistent from period to period, such as the termination of certain leveraged leases. Accordingly, the comparability of the effective tax rate from period to period may be impacted.

In the first quarter of 2015, the Company adopted new accounting guidance that allows companies with affordable housing tax credit investments to apply a proportional amortization method that recognizes the cost of the investment as a component of income tax expense. This election resulted in an increase to income tax expense, and the resulting effective tax rate. Prior periods have been restated for this change. Refer to Note 1 "Basis of Presentation" for additional information.

At March 31, 2015, the Company reported a net deferred tax asset of $254 million, compared to $368 million at December 31, 2014. The decrease in the net deferred tax asset is primarily due to market valuation adjustments on securities available for sale and derivative instruments as well as decreases related to employee benefits.

DISCONTINUED OPERATIONS

Morgan Keegan was sold on April 2, 2012. Regions' results from discontinued operations are presented in Note 2 "Discontinued Operations" to the consolidated financial statements. The first quarter of 2015 loss from discontinued operations was primarily the result of legal fees incurred during the quarter.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

Reference is made to pages 73 through 76 included in Management's Discussion and Analysis.

Item 4. Controls and Procedures

Based on an evaluation, as of the end of the period covered by this Form 10-Q, under the supervision and with the participation of Regions' management, including its Chief Executive Officer and Chief Financial Officer, the Chief Executive Officer and Chief Financial Officer have concluded that Regions' disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) are effective. During the quarter ended March 31, 2015, there have been no changes in Regions' internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, Regions' internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings
Information required by this item is set forth in Note 14, “Commitments, Contingencies and Guarantees” in the Notes to the Consolidated Financial Statements (Unaudited) in Part I. Item 1. of this report, which is incorporated herein by reference.
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Information concerning Regions’ repurchases of its outstanding common stock during the three month period ended March 31, 2015, is set forth in the following table.
Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Plans or Programs |
|---|---|---|---|---|
| January 1-31, 2015 | 10,995,388 | $9.01 | 10,995,388 | $3,190,652 |
| February 1-28, 2015 | 300,000 | $9.07 | 300,000 | $— |
| March 1-31, 2015 | — | $— | — | $— |
| Total 1st Quarter | 11,295,388 | $9.01 | 11,295,388 | $— |

On April 24, 2014, Regions' Board of Directors authorized a $350 million common stock repurchase plan, permitting repurchases from the beginning of the second quarter of 2014 through the end of the first quarter of 2015. During the first quarter of 2015, Regions concluded the plan with the repurchase of approximately 11 million shares of common stock at a total cost of approximately $102 million.
On April 23, 2015, Regions' Board of Directors authorized a new $875 million common stock purchase plan, permitting repurchases from the beginning of the second quarter of 2015 through the end of the second quarter of 2016. The Company began purchasing shares pursuant to this plan in April 2015, and as of May 5, 2015, Regions had repurchased approximately 7 million shares of common stock at a total cost of approximately $68 million. These shares were immediately retired upon repurchase and therefore will not be included in treasury stock.
Restrictions on Dividends and Repurchase of Stock
Holders of Regions common stock are only entitled to receive such dividends as Regions’ Board of Directors may declare out of funds legally available for such payments. Furthermore, holders of Regions common stock are subject to the prior dividend rights of the holders of Regions preferred stock then outstanding.
Regions understands the importance of returning capital to shareholders. Management will continue to execute the capital planning process, including evaluation of the amount of the common dividend, with the Board of Directors and in conjunction with the regulatory supervisors, subject to the Company’s results of operations. Also, Regions is a bank holding company, and its ability to declare and pay dividends is dependent on certain federal regulatory considerations, including the guidelines of the Federal Reserve regarding capital adequacy and dividends.
On November 1, 2012, Regions completed the sale of 20 million depositary shares each representing a 1/40th ownership interest in a share of its 6.375% Non-Cumulative Perpetual Preferred Stock, Series A, par value $1.00 per share (“Series A Preferred Stock”), with a liquidation preference of $1,000 per share of Series A Preferred Stock (equivalent to $25 per depositary share). The terms of the Series A Preferred Stock prohibit Regions from declaring or paying any dividends on any junior series of its capital stock, including its common stock, or from repurchasing, redeeming or acquiring such junior stock, unless Regions has declared and paid full dividends on the Series A Preferred Stock for the most recently completed dividend period. The Series A Preferred Stock is redeemable at Regions’ option in whole or in part, from time to time, on any dividend payment date on or after December 15, 2017,

or in whole, but not in part, at any time within 90 days following a regulatory capital treatment event (as defined in the certificate of designations establishing the Series A Preferred Stock).

On April 29, 2014, Regions completed the sale of 20 million depositary shares each representing a 1/40th ownership interest in a share of its 6.375% Fixed-to-Floating Rate Non-Cumulative Perpetual Preferred Stock, Series B, par value $1.00 per share ("Series B Preferred Stock"), with a liquidation preference of $1,000 per share of Series B Preferred Stock (equivalent to $25 per depositary share). The terms of the Series B Preferred Stock prohibit Regions from declaring or paying any dividends on any junior series of its capital stock, including its common stock, or from repurchasing, redeeming or acquiring such junior stock, unless

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Regions has declared and paid full dividends on the Series B Preferred Stock for the most recently completed dividend period. The Series B Preferred Stock is redeemable at Regions' option in whole or in part, from time to time, on any dividend payment date on or after September 15, 2024, or in whole but not in part, at any time following a regulatory capital treatment event (as defined in the certificate of designations establishing the Series B Preferred Stock).

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Item 6. Exhibits

The following is a list of exhibits including items incorporated by reference

| | |
|---|---|
| 3.1 | Amended and Restated Certificate of Incorporation, incorporated by reference to Exhibit 3.1 to Form 10-Q Quarterly Report filed by registrant on August 6, 2012. |
| 3.2 | Certificate of Designations, incorporated by reference to Exhibit 3.3 to Form 8-A filed by registrant on November 1, 2012. |
| 3.3 | Certificate of Designations, incorporated by reference to Exhibit 3.3 to the Form 8-A filed by registrant on April 28, 2014. |
| 3.4 | By-laws as amended and restated, incorporated by reference to Exhibit 3.2 to Form 8-K Current Report filed by registrant on February 12, 2015. |
| 10.1 | Amendment Number One to the Regions Financial Corporation Supplemental 401(k) Plan Restated as of January 1, 2014, incorporated by reference to Exhibit 10.38 to Form 10-K Annual Report filed by registrant on February 17, 2015. |
| 12 | Computation of Ratio of Earnings to Fixed Charges. |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | Interactive Data File |

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SIGNATURES

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

DATE: May 6, 2015

Regions Financial Corporation

/S/ HARDIE B. KIMBROUGH, JR.
Hardie B. Kimbrough, Jr.
Executive Vice President and Controller
(Chief Accounting Officer and Authorized Officer)

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