

RLI CORP
Form 10-K
February 25, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2008

or

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number 001-09463

RLI CORP.

(Exact name of registrant as specified in its charter)

Illinois
(State or other jurisdiction of incorporation or organization)

9025 North Lindbergh Drive, Peoria, Illinois
(Address of principal executive offices)

37-0889946
(I.R.S. Employer Identification No.)

61615
(Zip Code)

Registrant's telephone number, including area code **(309) 692-1000**

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

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| 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 No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

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 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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.

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The aggregate market value of the registrant's common stock held by non-affiliates of the Registrant as of June 30, 2008, based upon the closing sale price of the Common Stock on June 30, 2008 as reported on the New York Stock Exchange, was \$876,307,820. Shares of Common Stock held directly or indirectly by each officer and director along with shares held by the Company ESOP have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of the Registrant's Common Stock, \$1.00 par value, on February 13, 2009 was 21,494,311.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the 2008 Financial Report to Shareholders for the past year ended December 31, 2008, are incorporated by reference into Parts I and II of this document.

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Portions of the Registrant's definitive Proxy Statement for the 2009 annual meeting of security holders to be held May 7, 2009, are incorporated herein by reference into Part III of this document.

Exhibit index is located on pages 57-58 of this document, which lists documents incorporated by reference herein.

PART I

Item 1. **Business**

RLI Corp. underwrites selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group. We conduct operations principally through three insurance companies. RLI Insurance Company, our principal subsidiary, writes multiple lines insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company, a subsidiary of RLI Insurance Company, writes surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company, a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines of insurance on an admitted basis in 49 states and the District of Columbia. We are an Illinois corporation that was organized in 1965. We have no material foreign operations.

We maintain an Internet website at <http://www.rlicorp.com>. We make available free of charge on our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed with or furnished to the Securities and Exchange Commission as soon as reasonably practicable after such materials are filed or furnished.

As a niche company, we offer specialty insurance coverages designed to meet specific insurance needs of targeted insured groups and underwrite particular types of coverage for certain markets that are underserved by the insurance industry, such as our difference in conditions coverages or oil and gas surety bonds. We also provide types of coverages not generally offered by other companies, such as our stand-alone personal umbrella policy. The excess and surplus market, which unlike the standard admitted market is less regulated and more flexible in terms of policy forms and premium rates, provides an alternative market for customers with hard-to-place risks. When we underwrite within the surplus lines market, we are selective in the line of business and type of risks we choose to write. Using our non-admitted status in this market allows us to tailor terms and conditions to manage these exposures more effectively than our admitted counterparts. Often the development of these specialty insurance coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients. Once a proposal is submitted, underwriters determine whether it would be a viable product in keeping with our business objectives.

We initially wrote specialty property and casualty insurance through independent underwriting agents. We opened our first branch office in 1984, and began to shift from independent underwriting agents to wholly-owned branch offices that market to wholesale producers. We also market certain coverages to retail producers from several of our casualty, surety and property operations. We produce a limited amount of business under agreements with managing general agents under the direction of our product vice presidents. The majority of business is marketed through our branch offices located throughout the United States.

For the year ended December 31, 2008, the following table provides the geographic distribution of our risks insured as represented by direct premiums earned for all coverages. For the year ended December 31, 2008, no other state accounted for 1.5 percent or more of total direct premiums earned for all coverages.

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| State | Direct Premiums Earned (in thousands) | Percent of Total |
|------------------------------|--|------------------|
| California | \$ 130,780 | 18.8% |
| New York | 106,108 | 15.2% |
| Florida | 88,000 | 12.6% |
| Texas | 55,888 | 8.0% |
| New Jersey | 25,787 | 3.7% |
| Illinois | 19,272 | 2.8% |
| Washington | 18,413 | 2.6% |
| Pennsylvania | 16,970 | 2.4% |
| Hawaii | 16,544 | 2.4% |
| Louisiana | 14,851 | 2.1% |
| Massachusetts | 11,257 | 1.6% |
| Michigan | 10,867 | 1.6% |
| Ohio | 10,465 | 1.5% |
| Arizona | 10,402 | 1.5% |
| All Other | 160,219 | 23.2% |
| Total direct premiums | \$ 695,823 | 100.0% |

In the ordinary course of business, we rely on other insurance companies to share risks through reinsurance. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk (known as facultative reinsurance). We have quota share, excess of loss and catastrophe reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. The arrangements allow us to pursue greater diversification of business and serve to limit the maximum net loss on catastrophes and large risks. Reinsurance is subject to certain risks, specifically market risk, which affects the cost of and the ability to secure these contracts, and credit risk, which is the risk that our reinsurers may not pay on losses in a timely fashion or at all. The following table illustrates, through premium volume, the degree to which we have utilized reinsurance during the past three years. For an expanded discussion of the impact of reinsurance on our operations, see Note 5 to our audited consolidated financial statements included in our 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

| Premiums Written (in thousands) | Year Ended December 31, | | |
|------------------------------------|-------------------------|------------|------------|
| | 2008 | 2007 | 2006 |
| Direct & Assumed | \$ 681,169 | \$ 739,334 | \$ 799,013 |
| Reinsurance ceded | (167,713) | (200,571) | (247,477) |
| Net | \$ 513,456 | \$ 538,763 | \$ 551,536 |

Specialty Insurance Market Overview

The specialty insurance market differs significantly from the standard market. In the standard market, insurance rates and forms are highly regulated, products and coverage are largely uniform with relatively predictable exposures, and companies tend to compete for customers on the basis of price. In contrast, the specialty market provides coverage for risks that do not fit the underwriting criteria of the standard carriers. Competition tends to focus less on price and more on availability, service and other value-based considerations. While specialty market exposures may have higher insurance risks than their standard market counterparts, we manage these risks to achieve higher financial returns. To reach our financial and operational goals, we must have extensive knowledge and expertise in our markets. Most of our risks are considered on an individual basis and restricted limits, deductibles, exclusions and surcharges are employed in order to respond to distinctive risk characteristics.

We operate in the excess and surplus insurance market and the specialty admitted insurance market.

Excess and Surplus Insurance Market

The excess and surplus market focuses on hard-to-place risks. Excess and surplus eligibility allows us to underwrite nonstandard market risks with more flexible policy forms and unregulated premium rates. This typically results in coverages that are more restrictive and more expensive than in the standard admitted market. The excess and surplus lines regulatory environment and production model also effectively filters submission flow and matches market opportunities to

our expertise and appetite. In 2008, the excess and surplus market represented approximately \$27 billion, or 5 percent, of the entire \$504 billion domestic property and casualty industry, as measured by direct premiums written. Our excess and surplus operation wrote gross premiums of \$321.6 million, or 47 percent, of our total gross premiums written.

Specialty Admitted Insurance Market

We also write business in the specialty admitted market. Most of these risks are unique and hard to place in the standard market, but for marketing and regulatory reasons, they must remain with an admitted insurance company. The specialty admitted market is subject to greater state regulation than the excess and surplus market, particularly with regard to rate and form filing requirements, restrictions on the ability to exit lines of business, premium tax payments and membership in various state associations, such as state guaranty funds and assigned risk plans. For 2008, our specialty admitted operations wrote gross premiums of \$359.6 million representing approximately 53 percent of our total gross premiums written for the year.

Business Segment Overview

Our segment data is derived using the guidance set forth in Statement of Financial Accounting Standards (SFAS) 131, Disclosures about Segments of an Enterprise and Related Information. As prescribed by the pronouncement, reporting is based on the internal structure and reporting of information as it is used by management. The segments of our insurance operations are casualty, property and surety. For additional information, see Note 11 to our audited consolidated financial statements included in our 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

Casualty Segment

General Liability

Our general liability business consists primarily of coverage for third party liability of commercial insureds including manufacturers, contractors, apartments and mercantile. Net premiums earned from this business totaled \$140.9 million, \$167.9 million and \$180.0 million, or 25 percent, 26 percent, and 28 percent of consolidated revenues for 2008, 2007, and 2006, respectively.

Commercial and Personal Umbrella Liability

Our commercial umbrella coverage is principally written in excess of primary liability insurance provided by other carriers and, to a modest degree, in excess of primary liability written by us. The personal umbrella coverage is written in excess of the homeowners and automobile liability coverage provided by other carriers, except in Hawaii, where some underlying homeowners coverage is written by us. Net premiums earned from this business totaled \$65.1 million, \$66.3 million and \$64.7 million, or 12 percent, 10 percent, and 10 percent of consolidated revenues for 2008, 2007, and 2006, respectively.

Commercial Transportation

Our transportation insurance facility in Atlanta provides automobile liability and physical damage insurance to local, intermediate and long haul truckers, public transportation risks and equipment dealers. In early 2005, we expanded our focus to include other types of commercial automobile risks. We also offer incidental, related insurance coverages, including general liability, commercial umbrella and excess liability, and motor truck cargo. The facility is staffed by highly experienced transportation underwriters who produce business through independent agents and brokers nationwide. Net premiums earned from this business totaled \$46.7 million, \$49.1 million, and \$48.3 million, or 8 percent of consolidated revenues for 2008, 2007, and 2006.

Executive Products

We provide a variety of professional liability coverages, such as directors and officers (D&O) liability insurance, employment practices liability and other miscellaneous professional liability coverages, for a variety of low to moderate classes of risks. We tend to focus on smaller accounts, avoiding the large account sector which is generally more sensitive to price competition. Our target accounts include publicly traded companies with market capitalization below \$5 billion (where we are writing part of the traditional D&O program), Clause 1 (also known as Side A coverage, which is direct liability coverage for the individual directors and officers), private companies, nonprofit organizations, and sole-sponsored and multi-employer fiduciary liability accounts. We successfully transitioned from primarily writing high layers of excess D&O for publicly traded companies to writing more Clause 1 coverage. Additionally, we are having success rounding out our portfolio by writing more fiduciary liability coverage, primary and excess D&O coverage for private companies and non-profit organizations. Net

premiums earned from this business totaled \$13.8 million, \$12.0 million, and \$13.0 million, or 2 percent of consolidated revenues for 2008, 2007, and 2006.

Specialty Program Business

We offer program business in a variety of areas, which are typically multiple coverages combined into a package or portfolio policy. Our program coverages include: commercial property, general liability, inland marine, and crime. We rely primarily on program administrators as sources for this business. Net premiums earned from this business totaled \$31.4 million, \$29.4 million, and \$25.5 million for 2008, 2007, and 2006, respectively. These amounts represent 6 percent, 5 percent, and 4 percent of consolidated revenues for 2008, 2007, and 2006, respectively.

Other

We offer a variety of other smaller programs in our casualty segment, including deductible buy-back, at-home business, and employer's excess indemnity. Net premiums earned from these lines totaled \$15.5 million, \$18.7 million, and \$16.6 million, or 3 percent of consolidated revenues for 2008, 2007, and 2006.

Property Segment

Commercial

Our commercial property coverage consists primarily of excess and surplus lines and specialty insurance such as fire, earthquake and difference in conditions, which can include earthquake, wind, flood and collapse coverages, and inland marine. We provide insurance for a wide range of commercial and industrial risks, such as office buildings, apartments, condominiums, and certain industrial and mercantile structures. We also write boiler and machinery coverage under the same management as commercial property. Net premiums earned from commercial property business totaled \$85.3 million, \$92.6 million, and \$91.5 million, or 15 percent, 14 percent, and 14 percent of consolidated revenues for 2008, 2007, and 2006, respectively.

Marine

In 2005, we launched a new marine insurance division. Marine coverages include hull, cargo and protection and indemnity (P&I), as well as inland marine coverages including builders' risks, contractors' equipment and other floater type coverages. In May 2007, the marine division added specialty cargo coverage that focuses on high-tech and life sciences risks. In March 2008, the marine division added a yacht program. In 2008, 2007 and 2006, marine net premiums earned totaled \$48.2 million, \$32.9 million and \$16.8 million, or 9 percent, 5 percent and 3 percent, respectively, of consolidated revenues.

Other

We offer a variety of other smaller programs in our property segment, including a limited amount of homeowners and dwelling fire insurance in Hawaii. We have reduced our Hawaii wind exposure through more restrictive underwriting over the last 18 months.

In July 2007, we launched a new division focusing on facultative reinsurance. The division is responsible for underwriting property facultative reinsurance for insurance companies utilizing reinsurance intermediaries.

Net premiums earned from the above coverages totaled \$13.4 million, \$12.9 million, and \$14.3 million, or 2 percent of consolidated revenues for 2008, 2007, and 2006.

Surety Segment

Our surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. We offer miscellaneous bonds, including license and permit, notary, and court bonds. In September 2008, we launched a new Fidelity Division focusing on fidelity and crime coverage for commercial insureds and select financial institutions. These bonds are written through independent agencies as well as regional and national brokers. Net earned premium totaled \$68.4 million, \$62.7 million, and \$59.5 million, or 12 percent, 10 percent and 9 percent of consolidated revenues for 2008, 2007, and 2006, respectively.

Competition

Our specialty property and casualty insurance subsidiaries are part of an extremely competitive industry that is cyclical and historically characterized by periods of high premium rates and shortages of underwriting capacity followed by periods of severe competition and excess underwriting capacity. Within the United States alone, approximately 2,400 companies, both stock and mutual, actively market property and casualty coverages. Our primary competitors in our casualty segment are, among others, Ace, Arch, James River, Landmark, Navigators, USLI, Great West, Lancer, National Interstate, Chubb, Philadelphia, Great American, Travelers and CNA. Our primary competitors in our property segment are, among others, Ace, Lexington, Arch, Crum & Forster, Travelers and Markel. Our primary competitors in our surety segment are, among others, Ace, Arch, HCC, CNA, Safeco, North American Specialty, Travelers and Hartford. The combination of coverages, service, pricing and other methods of competition vary from line to line. Our principal methods of meeting this competition are innovative coverages, marketing structure and quality service to the agents and policyholders at a fair price. We compete favorably in part because of our sound financial base and reputation, as well as our broad geographic penetration into all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. In the property and casualty area, we have acquired experienced underwriting specialists in our branch and home offices. We have continued to maintain our underwriting and marketing standards by not seeking market share at the expense of earnings. We have a track record of withdrawing from markets when conditions become overly adverse. We offer new coverages and new programs where the opportunity exists to provide needed insurance coverage with exceptional service on a profitable basis.

Ratings

A.M. Best ratings for the industry range from A++ (Superior) to F (In Liquidation) with some companies not being rated. Standard & Poor's ratings for the industry range from AAA (Extremely strong) to R (Regulatory Action). Moody's ratings for the industry range from Aaa (Exceptional) to C (Lowest). The following table illustrates the range of ratings assigned by each of the three major rating companies that has issued a financial strength rating on our insurance companies:

| A.M. Best SECURE | | Standard & Poor's SECURE | | Moody's STRONG | |
|---------------------|------------------------------|-----------------------------|-------------------|-------------------|----------------|
| A++, A+ | Superior | AAA | Extremely strong | Aaa | Exceptional |
| A,A- | Excellent | AA | Very strong | Aa | Excellent |
| B++, B+ | Very good | A | Strong | A | Good |
| | | BBB | Good | Baa | Adequate |
| VULNERABLE | | VULNERABLE | | WEAK | |
| B,B- | Fair | BB | Marginal | Ba | Questionable |
| C++,C+ | Marginal | B | Weak | B | Poor |
| C,C- | Weak | CCC | Very weak | Caa | Very poor |
| D | Poor | CC | Extremely weak | Ca | Extremely poor |
| E | Under regulatory supervision | R | Regulatory action | C | Lowest |
| F | In liquidation | | | | |
| S | Rating suspended | | | | |

Within-category modifiers +,-

1,2,3 (1 high, 3 low)

Publications of A.M. Best, Standard & Poor's and Moody's indicate that A and A+ ratings are assigned to those companies that, in their opinion, have achieved excellent overall performance when compared to the standards established by these firms and have a strong ability to meet their obligations to policyholders over a long period of time. In evaluating a company's financial and operating performance, each of the firms reviews the company's profitability, leverage and liquidity, as well as the company's spread of risk, the quality and appropriateness of its reinsurance, the quality and diversification of its assets, the adequacy of its policy and loss reserves, the adequacy of its surplus, its capital structure, its risk

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management practices and the experience and objectives of its management. These ratings are based on factors relevant to policyholders, agents, insurance brokers and intermediaries and are not directed to the protection of investors.

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At December 31, 2008, the following ratings were assigned to our insurance companies:

A.M. Best

| | |
|--|--------------|
| RLI Insurance, Mt. Hawley Insurance, and RLI Indemnity (RLI Group) | A+, Superior |
|--|--------------|

Standard & Poor's

| | |
|--|------------|
| RLI Insurance and Mt. Hawley Insurance | A+, Strong |
|--|------------|

Moody's

| | |
|---|----------|
| RLI Insurance, Mt. Hawley Insurance and RLI Indemnity | A2, Good |
|---|----------|

For A.M. Best, Standard & Poor's and Moody's, the financial strength ratings represented above are affirmations of previously assigned ratings.

A.M. Best, in addition to assigning a financial strength rating, also assigns financial size categories. During 2008, RLI Insurance Company, Mt. Hawley Insurance Company and RLI Indemnity Company, collectively referred to as RLI Group, were assigned a financial size category of X (adjusted policyholders' surplus of between \$500 and \$750 million). As of December 31, 2008, the policyholders' statutory surplus of RLI Group totaled \$678.0 million.

RLI Corp's existing \$100 million of senior notes maturing in 2014 maintains a Standard & Poor's rating of BBB+, Moody's Baa2, and a Fitch rating of BBB.

Reinsurance

We reinsure a portion of our property and casualty insurance exposure, paying or ceding to the reinsurer a portion of the premiums received on such policies. Earned premiums ceded to non-affiliated reinsurers totaled \$172.3 million, \$227.1 million, and \$264.5 million in 2008, 2007, and 2006, respectively. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. While reinsurance does not relieve us of our legal liability to our policyholders, we use reinsurance as an alternative to using our own capital to fund losses. Retention levels are adjusted each year to maintain a balance between the growth in surplus and the cost of reinsurance. Although reinsurance does not legally discharge an insurer from its primary liability for the full amount of the policies, it does make the assuming reinsurer liable to the insurer to the extent of the insurance ceded.

Reinsurance is subject to certain risks, specifically market risk (which affects the cost of and the ability to secure reinsurance contracts) and credit risk (which relates to the ability to collect from the reinsurer on our claims). We purchase reinsurance from a number of financially strong reinsurers. We evaluate reinsurers' ability to pay based on their financial results, level of surplus, financial strength ratings, and other risk characteristics. A reinsurance committee, comprised of senior management, approves our security guidelines and reinsurer usage. Each of the top 10 largest reinsurers (listed below and ranked based on amounts recoverable) are rated A- or better by A.M. Best and Standard and Poor's rating services. Additionally, more than 91 percent of our reinsurance recoverables are due from companies rated A or better by A.M. Best and Standard & Poor's rating services.

The following table sets forth the ten largest reinsurers in terms of amounts recoverable, net of collateral we are holding from such reinsurers, as of December 31, 2008. Also shown are the amounts of written premium ceded to these reinsurers during the calendar year 2008.

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| (dollars in thousands) | A.M. Best Rating | S & P Rating | Net Reinsurer Exposure as of 12/31/2008 | Percent of Total | Ceded Premiums Written | Percent of Total |
|--------------------------------|------------------|--------------|---|------------------|------------------------|------------------|
| Munich Re America | A+ | AA- | \$ 59,716 | 15.9% | \$ 23,909 | 14.3% |
| Swiss Re / Westport Ins. Corp. | A+ | A+ | 41,660 | 11.1% | 8,125 | 4.8% |
| Endurance Re | A | A | 40,632 | 10.8% | 14,750 | 8.8% |
| Axis Re | A | A | 32,743 | 8.7% | 14,931 | 8.9% |
| General Cologne Re | A++ | AAA | 31,839 | 8.4% | 2,053 | 1.2% |
| Berkley Insurance Co. | A+ | A+ | 28,202 | 7.5% | 6,081 | 3.6% |
| Toa-Re | A | A+ | 17,916 | 4.7% | 5,476 | 3.3% |
| Lloyds of London | A | A+ | 15,184 | 4.0% | 16,319 | 9.7% |
| Ace Property & Casualty | A+ | A+ | 15,078 | 4.0% | 5,702 | 3.4% |
| Transatlantic Re | A | AA- | 14,892 | 4.0% | 8,558 | 5.1% |
| All other reinsurers | | | 78,513 | 20.9% | 61,809 | 36.9% |
| Total ceded exposure | | | \$ 376,375 | 100.0% | \$ 167,713 | 100.0% |

We utilize both treaty and facultative reinsurance coverage for our risks. Treaty coverage refers to a reinsurance contract that is applied to a group or class of business where all the risks written meet the criteria for that class. Facultative coverage is applied to individual risks as opposed to a group or class of business. It is used for a variety of reasons including supplementing the limits provided by the treaty coverage or covering risks or perils excluded from treaty reinsurance.

Much of our reinsurance is purchased on an excess of loss basis. Under an excess of loss arrangement, we retain losses on a risk up to a specified amount and the reinsurers assume any losses above that amount. We may choose to participate in the reinsurance layers purchased by retaining a percentage of the layer. It is common to find conditions in excess of loss covers such as occurrence limits, aggregate limits and reinstatement premium charges. Occurrence limits cap our recovery for multiple losses caused by the same event. Aggregate limits cap our recovery for all losses ceded during the contract term. We may be required to pay additional premium to reinstate or have access to use the reinsurance limits for potential future recoveries during the same contract year. Our property and surety treaties tend to include reinstatement provisions.

We analyze our reinsurance covers in conjunction with our three segments: property, casualty and surety.

In the property segment, the reinsurance structure is divided into three categories: commercial property, catastrophe earthquake and catastrophe other than earthquake, which could include such events as hurricanes, windstorm, hailstorms, explosions, severe winter weather, fires, etc.

Commercial Property Reinsurance

Our commercial property treaty renews annually on January 1. In 2009, 2008, 2007, and 2006, for most risks, we retain the first \$1.0 million in losses. We purchase treaty reinsurance for the next \$9.0 million in limit. We retain \$600,000 within the treaty. In 2006, we retained \$1.0 million within the treaty.

The marine treaty renews May 1 annually. For marine exposures, we retain the first \$1.0 million in losses. Reinsurance covers 100 percent of the next \$39.0 million. For the 2007 treaty, we retained the first \$1.0 million in losses and purchased coverage for 100 percent of the next \$29.0 million.

million. For the 2006 treaty, we retained the first \$0.5 million in losses. We purchased \$19.5 million of reinsurance and retained \$0.4 million within the treaty structure.

Property Reinsurance- Catastrophe (CAT) Coverage

Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our property segment. Catastrophes involve multiple claims and policyholders. Reinsurance limits purchased fluctuate due to changes in the number of policies we insure, reinsurance costs, insurance company surplus levels, and our risk appetite. In addition, we monitor the expected rate of return for each of our catastrophe lines of business. At high rates of return, we grow the book of business and may purchase additional reinsurance depending on our capital position. As the rate of return decreases, we shrink the book and may purchase less reinsurance. For the last three years, we have maintained a \$25.0 million first dollar retention. For 2009, we purchased \$350.0 million in limit above our retention. We purchased \$375.0 million in limit in 2008 which decreased to \$350.0 million at July 1, 2008. In 2007, we purchased \$475.0 million in catastrophe reinsurance which decreased to \$425.0 million at July 1, 2007. These CAT limits are in addition to the per-occurrence coverage provided by facultative and other treaty coverages. We have participated in the catastrophe layers purchased by retaining a percentage of each layer throughout this period. Our participation has varied based on price and the amount of risk transferred by each layer.

Our property catastrophe program continues to be on an excess of loss basis. It attaches after all other reinsurance has been considered. Although covered in one program, limits and attachment points differ for California earthquakes and all other perils. The following charts use information from our catastrophe modeling software to illustrate our net retention resulting from particular events that would generate the listed levels of gross losses:

Catastrophe - California Earthquake
(in millions)

| Projected Gross Loss | 2008 | | | 2007 | | | 2006 | | |
|----------------------|--------------|------------|--|--------------|------------|--|--------------|------------|--|
| | Ceded Losses | Net Losses | | Ceded Losses | Net Losses | | Ceded Losses | Net Losses | |
| \$ 50 | \$ 7 | \$ 43 | | \$ 6 | \$ 44 | | \$ 21 | \$ 29 | |
| 100 | 50 | 50 | | 52 | 48 | | 51 | 49 | |
| 200 | 139 | 61 | | 139 | 61 | | 135 | 65 | |
| 400 | 321 | 79 | | 320 | 80 | | 299 | 101 | |

Catastrophe - Other (Earthquake outside of California, Wind, etc.)
(in millions)

| Projected Gross Loss | 2008 | | | 2007 | | | 2006 | | |
|----------------------|--------------|------------|--|--------------|------------|--|--------------|------------|--|
| | Ceded Losses | Net Losses | | Ceded Losses | Net Losses | | Ceded Losses | Net Losses | |
| \$ 25 | \$ 6 | \$ 19 | | \$ 6 | \$ 19 | | \$ 18 | \$ 7 | |
| 50 | 29 | 21 | | 29 | 21 | | 41 | 9 | |
| 100 | 73 | 27 | | 76 | 24 | | 84 | 16 | |
| 200 | 162 | 38 | | 163 | 37 | | 168 | 32 | |

These tables were generated using theoretical probabilities of events occurring in areas where our portfolio of currently in-force policies could generate the level of loss shown. Actual results could vary significantly from these tables as the actual nature or severity of a particular event cannot be predicted with any reasonable degree of accuracy. Reinsurance limits are purchased based on the anticipated losses to large events. The largest losses shown above are unlikely to occur based on the probability of those events occurring. However, there is a remote chance that a larger event could occur. If the actual event losses are larger than anticipated, we could retain additional losses above the limit of our catastrophe reinsurance.

Our catastrophe program includes one prepaid reinstatement for the first two layers of coverage, up to \$100 million, for a catastrophe other than California earthquake. If a loss does occur, reinstatement must be purchased for the remaining limits. For a California earthquake, there is a prepaid reinstatement for the \$50.0 million excess \$50.0 million layer (placed at 77 percent) and a reinstatement must be purchased for the remaining limits.

We continuously monitor and quantify our exposure to catastrophes, including earthquakes, hurricanes, terrorist acts, and other catastrophic events. In the normal course of business, we manage our concentrations of exposures to catastrophic events, primarily by limiting concentrations of exposure to acceptable levels and by purchasing reinsurance. Exposure and coverage detail is recorded for each risk location. We quantify and monitor the total policy limit insured in each region. In addition, we use third party catastrophe exposure models and an internally developed analysis to assess each risk and ensure we include an appropriate charge for assumed catastrophe risks. Catastrophe exposure modeling is inherently uncertain due to the model's reliance on an infrequent observation of actual events and exposure data, increasing the importance of capturing accurate policy coverage data. The model results are used both in the underwriting analysis of individual risks, and at a corporate level for the aggregate book of catastrophe-exposed business. From both perspectives, we consider the potential loss produced by individual events that represent moderate-to-high loss potential at varying return periods and magnitudes. In calculating potential losses, we select appropriate assumptions, including but not limited to loss amplification and storm surge. We establish risk tolerances at the portfolio level based on market conditions, the level of reinsurance available, changes to the assumptions in the catastrophe models, rating agency capital constraints, underwriting guidelines and coverages, and internal preferences. Our risk tolerances for each type of catastrophe, and for all perils in aggregate, change over time as these internal and external conditions change.

Casualty Reinsurance

Our 2009 casualty reinsurance includes both excess of loss treaties and quota share treaties, as was the case in 2008, and 2007. Annually on January 1, we place a Combined Casualty Treaty that incorporates coverage for a majority of our casualty lines. In 2009, we added transportation to the treaty effective May 1, 2009. Our first dollar retention on those lines of

business covered ranges from \$0.5 million to \$1.0 million. Considering our participation in the reinsurance layers placed, our retention on a full limits loss ranges from \$0.5 million to \$1.5 million. Maximum reinsurance limits purchased are \$10.0 million inclusive of our retention for the last three years. With respect to our 2008 Combined Casualty Treaty, we retained the initial \$0.5 million to \$1.0 million in loss. Our total retention considering participation in the reinsurance layers purchased ranged from \$1.3 million to \$1.4 million depending on the type of policy. This was also the case in 2007. For our transportation coverage, the separate treaty renews on May 1 annually. In 2008, we retained the first \$0.5 million in loss. We purchased between \$1.5 million and \$4.5 million of reinsurance limit depending on the type of risk for the last three years. Our total retention inclusive of treaty participation ranged from \$0.6 million and \$1.0 million. We also retained the first \$0.5 million in loss in our 2007 treaty. Our total retention inclusive of treaty participation ranged from \$0.6 million and \$0.9 million. For the 2006 treaty, our first dollar retention was \$0.5 million and we placed 100 percent of the reinsurance limits purchased.

Our executive products group (EPG) treaty renews on July 1 annually. We have purchased quota share treaties over the last three years and have varied our percentage of participation. In 2008, our reinsurance limit increased to \$25.0 million. Our maximum retained loss on a policy does not exceed \$7.5 million. In 2007 and 2006, we purchased reinsurance limits up to \$20.0 million. In 2007 and 2006, our maximum retained loss on any EPG policy was \$6.0 million and \$4.0 million, respectively.

Surety Reinsurance

Our surety reinsurance treaty renews on April 1 annually. The treaty is on an excess of loss basis. In 2008, we purchased reinsurance limits of \$49.0 million above our \$1.0 million first dollar retention. Within the reinsurance treaty, we participate up to a maximum retention of \$6.3 million for any one principal. We purchased \$34.0 million of reinsurance limit in 2007 above our first dollar retention of \$1.0 million. Our maximum retention considering treaty participation was \$8.0 million. In 2006, we purchased \$24.0 million in limit with a \$7.0 million maximum retention inclusive our first dollar retention of \$1.0 million. For a majority of risks, our potential net loss did not exceed \$2.0 million.

During 2008, we purchased a separate quota share treaty for our new fidelity product line. We retain up to \$3.8 million in losses with a limit of \$25.0 million. This treaty has a renewal date of March 1, 2010.

Marketing and Distribution

We distribute our coverages primarily through branch offices throughout the country that market to wholesale and retail brokers and through independent agents. We also market through agencies and more recently through e-commerce channels.

Broker Business

The largest volume of broker-generated premium is in our commercial property, general liability, commercial surety, commercial umbrella and commercial automobile coverages. This business is produced through wholesale and retail brokers who are not affiliated with us.

Independent Agent Business

Our surety segment offers its business through a variety of independent agents. Additionally, we write program business, such as at-home business and personal umbrella, through independent agents. Homeowners and dwelling fire is produced through independent agents in Hawaii. Each of these programs involves detailed eligibility criteria, which are incorporated into strict underwriting guidelines, and prequalification of each risk using a system accessible by the independent agent. The independent agent cannot bind the risk unless they receive approval through our system.

Underwriting Agents

We contract with certain underwriting agencies who have limited authority to bind or underwrite business on our behalf. The underwriting agreements involve strict underwriting guidelines and the agents are subject to audits upon request. These agencies may receive some compensation through contingent profit commission.

E-commerce

We are actively employing e-commerce to produce and efficiently process and service business, including package policies for limited service motel/hotel operations, restaurant/bar/tavern operations and at-home businesses, small commercial and personal umbrella risks and surety bonding.

Environmental, Asbestos, and Mass Tort Exposures

We are subject to environmental site cleanup, asbestos removal, and mass tort claims and exposures through our commercial umbrella, general liability, and discontinued assumed casualty reinsurance lines of business. The majority of the exposure is in the excess layers of our commercial umbrella and assumed reinsurance books of business.

The following table represents inception-to-date paid and unpaid environmental, asbestos, and mass tort claims data (including incurred but not reported losses) as of December 31, 2008, 2007, and 2006:

| (dollars in thousands) | 2008 | Inception-to-date at December 31, 2007 | 2006 |
|---|-----------|--|-----------|
| Loss and Loss Adjustment Expense (LAE) payments | | | |
| Gross | \$ 70,210 | \$ 56,060 | \$ 53,323 |
| Ceded | (39,143) | (30,607) | (29,853) |
| Net | \$ 31,067 | \$ 25,453 | \$ 23,470 |
| Unpaid losses and LAE at end of year | | | |
| Gross | \$ 65,583 | \$ 67,891 | \$ 48,541 |
| Ceded | (20,407) | (29,198) | (25,720) |
| Net | \$ 45,176 | \$ 38,693 | \$ 22,821 |

Our environmental, asbestos and mass tort exposure is limited, relative to other insurers, as a result of entering the affected liability lines after the insurance industry had already recognized environmental and asbestos exposure as a problem and adopted appropriate coverage exclusions. During 2008, payment activity was more than we experienced in 2007, which was not surprising given the increased amount of case reserve activity during 2007. However, we did not observe a corresponding decrease in case reserves, as gross case reserves decreased by only \$4.8 million while net case reserves increased by about \$0.5 million. Much of the reported adverse development can be tied to a small number of claims. Two related asbestos claims from our assumed reinsurance book accounted for \$2.7 million in gross emergence and \$2.1 million in net emergence with large payments being made. A mass tort claim from accident year 2005 against an insured hotel involving carbon monoxide discharge accounted for another \$1.6 million direct and \$1.0 million net. In light of these developments and a few additional reported claims, we decided to strengthen our incurred but not reported (IBNR) position.

During 2007, while payment activity was less than we experienced in 2006, we experienced an unusual amount of case reserve activity. About two-thirds of the increase in net reserves was from case reserve adjustments. A \$4.8 million case reserve increase was posted due to a reversal of a previous court decision for a claim involving pollution during the late 1980s. In addition, an insurance company we reinsured in the early 1980s and that went into liquidation in 1986, reported a number of claims in 2007. The largest of these involves asbestos. Because of this situation, we posted total net case reserves of \$2.9 million. Also, a \$2.2 million reserve adjustment was made on a 1983 asbestos related claim because the coverage layers below our excess policy had been exhausted. In addition to these case reserve increases, we made a minor adjustment in our emergence pattern assumptions that resulted in an increase in our total reserve position relative to industry benchmarks.

While our environmental exposure is limited, the ultimate liability for this exposure is difficult to assess because of the extensive and complicated litigation involved in the settlement of claims and evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, we participate primarily in the excess layers of coverage, where accurate estimates of ultimate loss are more difficult to derive than for primary coverage.

Losses and Settlement Expenses

Overview

Loss and loss adjustment expense (LAE) reserves represent our best estimate of ultimate amounts for losses and related settlement expenses from claims that have been reported but not paid, and those losses that have occurred but have not yet been reported to us. Loss reserves do not represent an exact calculation of liability, but instead represent our estimates, generally utilizing individual claim estimates and actuarial expertise and estimation techniques at a given accounting date. The loss reserve estimates are expectations of what ultimate settlement and administration of claims will cost upon final resolution. These estimates are based on facts and circumstances then known to us, review of historical settlement patterns, estimates of

trends in claims frequency and severity, projections of loss costs, expected interpretations of legal theories of liability, and many other factors. In establishing reserves, we also take into account estimated recoveries, reinsurance, salvage, and subrogation. The reserves are reviewed regularly by a team of actuaries we employ.

The process of estimating loss reserves involves a high degree of judgment and is subject to a number of variables. These variables can be affected by both internal and external events, such as changes in claims handling procedures, claim personnel, economic inflation, legal trends, and legislative changes, among others. The impact of many of these items on ultimate costs for loss and LAE is difficult to estimate. Loss reserve estimations also differ significantly by coverage due to differences in claim complexity, the volume of claims, the policy limits written, the terms and conditions of the underlying policies, the potential severity of individual claims, the determination of occurrence date for a claim, and reporting lags (the time between the occurrence of the policyholder event and when it is actually reported to the insurer). Informed judgment is applied throughout the process. We continually refine our loss reserve estimates as historical loss experience develops and additional claims are reported and settled. We rigorously attempt to consider all significant facts and circumstances known at the time loss reserves are established.

Due to inherent uncertainty underlying loss reserve estimates, including but not limited to the future settlement environment, final resolution of the estimated liability may be different from that anticipated at the reporting date. Therefore, actual paid losses in the future may yield a materially different amount than currently reserved favorable and unfavorable.

The amount by which estimated losses differ from those originally reported for a period is known as development. Development is unfavorable when the losses ultimately settle for more than the levels at which they were reserved or subsequent estimates indicate a basis for reserve increases on unresolved claims. Development is favorable when losses ultimately settle for less than the amount reserved or subsequent estimates indicate a basis for reducing loss reserves on unresolved claims. We reflect favorable or unfavorable developments of loss reserves in the results of operations in the period the estimates are changed.

We record two categories of loss and LAE reserves case-specific reserves and IBNR reserves.

Within a reasonable period of time after a claim is reported, our claim department completes an initial investigation and establishes a case reserve. This case-specific reserve is an estimate of the ultimate amount we will have to pay for the claim, including related legal expenses and other costs associated with resolving and settling a particular claim. The estimate reflects all of the current information available regarding the claim, the informed judgment of our professional claim personnel, our reserving practices and experience, and the knowledge of such personnel regarding the nature and value of the specific type of claim. During the life cycle of a particular claim, more information may materialize that causes us to revise the estimate of the ultimate value of the claim either upward or downward. We may determine that it is appropriate to pay portions of the reserve to the claimant or related settlement expenses before final resolution of the claim. The amount of the individual claim reserve will be adjusted accordingly and is based on the most recent information available.

We establish IBNR reserves to estimate the amount we will have to pay for claims that have occurred, but have not yet been reported to us; claims that have been reported to us that may ultimately be paid out differently than expected by our case-specific reserves; and claims that have been paid and closed, but may reopen and require future payment.

Our IBNR reserving process involves three steps including an initial IBNR generation process that is prospective in nature; a loss and LAE reserve estimation process that occurs retrospectively; and a subsequent discussion and reconciliation between our prospective and retrospective IBNR estimates which includes changes in our provisions for IBNR where deemed appropriate. These three processes are discussed in more

detail in the following sections.

LAE represents the cost involved in adjusting and administering losses from policies we issued. The LAE reserves are frequently separated into two components: allocated and unallocated. Allocated loss adjustment expense (ALAE) reserves represent an estimate of claims settlement expenses that can be identified with a specific claim or case. Examples of ALAE would be the hiring of an outside adjuster to investigate a claim or an outside attorney to defend our insured. The claims professional typically estimates this cost separately from the loss component in the case reserve. Unallocated loss adjustment expense (ULAE) reserves represent an estimate of claims settlement expenses that cannot be identified with a specific claim. An example of ULAE would be the cost of an internal claims examiner to manage or investigate a reported claim.

All decisions regarding our best estimate of ultimate loss and LAE reserves are made by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at December 31, 2008, make a reasonable provision to meet our future obligations.

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Net loss and loss adjustment reserves by product line at year-end 2008 and 2007 were as follows:

| (as of December 31, in \$ thousands) Product Line | 2008 | | | 2007 | | |
|--|------------|------------|------------|------------|------------|------------|
| | Case | IBNR | Total | Case | IBNR | Total |
| <i>Casualty segment net loss and ALAE reserves</i> | | | | | | |
| Commercial umbrella | \$ 3,878 | \$ 24,569 | \$ 28,447 | \$ 7,051 | \$ 32,666 | \$ 39,717 |
| Personal umbrella | 16,591 | 35,717 | 52,308 | 19,101 | 31,498 | 50,599 |
| General liability | 89,094 | 250,640 | 339,734 | 84,222 | 242,754 | 326,976 |
| Transportation | 58,806 | 10,701 | 69,507 | 59,569 | 10,209 | 69,778 |
| Executive products | 9,143 | 30,470 | 39,613 | 4,291 | 26,185 | 30,476 |
| Other casualty | 35,933 | 71,299 | 107,232 | 34,984 | 70,074 | 105,058 |
| <i>Property segment net loss and ALAE reserves</i> | | | | | | |
| Difference in conditions | 516 | 6,062 | 6,578 | 617 | 6,372 | 6,989 |
| Marine | 18,080 | 16,092 | 34,172 | 10,420 | 10,337 | 20,757 |
| Other property | 25,358 | 9,821 | 35,179 | 21,946 | 13,378 | 35,324 |
| <i>Surety segment net loss and ALAE reserves</i> | | | | | | |
| | 4,365 | 11,347 | 15,712 | 4,759 | 14,564 | 19,323 |
| <i>Latent liability net loss and ALAE reserves</i> | | | | | | |
| | 21,605 | 23,571 | 45,176 | 21,103 | 17,590 | 38,693 |
| <i>Total net loss and ALAE reserves</i> | 283,369 | 490,289 | 773,658 | 268,063 | 475,627 | 743,690 |
| <i>ULAE reserves</i> | | 35,369 | 35,369 | | 31,238 | 31,238 |
| <i>Total net loss and LAE reserves</i> | \$ 283,369 | \$ 525,658 | \$ 809,027 | \$ 268,063 | \$ 506,865 | \$ 774,928 |

Initial IBNR Generation Process

Initial carried IBNR reserves are determined through a reserve generation process. The intent of this process is to establish an initial total reserve that will provide a reasonable provision for the ultimate value of all unpaid loss and ALAE liabilities. For most casualty and surety products, this process involves the use of an initial loss and ALAE ratio that is applied to the earned premium for a given period. The result is our best initial estimate of the expected amount of ultimate loss and ALAE for the period by product. Paid and case reserves are subtracted from this initial estimate of ultimate loss and ALAE to determine a carried IBNR reserve.

For most property products, we use an alternative method of determining an appropriate provision for initial IBNR. Since this segment is characterized by a shorter period of time between claim occurrence and claim settlement, the IBNR reserve is determined by an initial loss percentage applied to the rolling 12 month's premium earned. No deductions for paid or case reserves are made. This alternative method of determining initial IBNR reacts more quickly to the actual loss emergence and is more appropriate for our property products where final claim resolution occurs quickly.

We do not reserve for natural or man-made catastrophes until an event has occurred. Shortly after such occurrence, we review insured locations exposed to the event, model loss estimates of the event based on our own exposures, and industry loss estimates of the event, and we consider our knowledge of frequency and severity from early claim reports to determine an appropriate reserve for the catastrophe. These reserves are reviewed frequently based on loss reports and appropriate changes to our estimates are made to reflect any new information as it arises.

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The initial loss and ALAE ratios that are applied to earned premium are reviewed at least semi-annually. Prospective estimates are made based on historical loss experience adjusted for mix and price change and loss cost inflation. The initial loss and ALAE ratios also reflect some provision for estimation risk. We consider estimation risk by segment and product line. A segment with greater overall volatility and uncertainty has greater estimation risk. Characteristics of segments and products with higher estimation risk, include those exhibiting, but not limited to, the following characteristics:

- significant changes in underlying policy terms and conditions,
- a new business or one experiencing significant growth and/or high turnover,
- small volume or lacking internal data requiring significant reliance on external data,
- longer emergence patterns with exposures to latent unforeseen mass tort,
- high severity and/or low frequency,

- operational processes undergoing significant change, and/or
- high sensitivity to significant swings in loss trends or economic change.

Following is a table of significant risk factors by major product line. We distinguish between loss ratio risk and reserve estimation risk. Loss ratio risk refers to the possible dispersion of loss ratios from year to year due to inherent volatility in the business such as high severity or aggregating exposures. Reserve estimation risk recognizes the difficulty in estimating a given year's ultimate loss liability. As an example, our property catastrophe business (identified below as "Difference in conditions") has significant variance in year-over-year results; however its reserving estimation risk is relatively low.

Significant Risk Factors

| Product line | Length of Reserve Tail | Emergence patterns relied upon | Other risk factors | Expected loss ratio variability | Reserve estimation variability |
|--------------------------|------------------------|---|---|---------------------------------|--------------------------------|
| Commercial umbrella | Long | Internal | Low frequency High severity Loss trend volatility Unforeseen tort potential Exposure changes/mix | High | High |
| Personal umbrella | Medium | Internal | Low frequency | Medium | Medium |
| General liability | Long | Internal | Exposure growth/mix Unforeseen tort potential | Medium | High |
| Transportation | Medium | Internal | High severity Exposure growth/mix | Medium | Medium |
| Executive products | Long | Internal & significant external reliances | Low frequency High severity Loss trend volatility Economic volatility Unforeseen tort potential Small volume | High | High |
| Other casualty | Medium | Internal & external | Small volume | Medium | Medium |
| Difference in conditions | Short | Internal | Catastrophe aggregation exposure Low frequency | High | Medium |

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| | | | | | |
|--|--------|-----------------------------------|---|--------|--------|
| Marine | Medium | Significant external reliances | High severity New business | High | High |
| Other property | Short | Internal | Small volume Catastrophe aggregation exposure | Medium | Low |
| Surety | Medium | Internal & external reliances | Economic volatility Uniqueness of exposure | Medium | Medium |
| Runoff including asbestos & environmental | Long | Internal & external reliances | Loss trend volatility Mass tort/latent exposure | High | High |

The historical and prospective loss and ALAE estimates along with the risks listed are the basis for determining our initial and subsequent carried reserves. Adjustments in the initial loss ratio by product and segment are made where necessary and reflect updated assumptions regarding loss experience, loss trends, price changes, and prevailing risk factors. The LRC makes all final decisions regarding changes in the initial loss and ALAE ratios.

Loss and LAE Reserve Estimation Process

A full analysis of our loss reserves takes place at least semi-annually. The purpose of these analyses is to provide validation of our carried loss reserves. Estimates of the expected value of the unpaid loss and LAE are derived using actuarial methodologies. These estimates are then compared to the carried loss reserves to determine the appropriateness of the current reserve balance.

The process of estimating ultimate payment for claims and claims expenses begins with the collection and analysis of current and historical claim data. Data on individual reported claims including paid amounts and individual claim adjuster estimates are grouped by common characteristics. There is judgment involved in this grouping. Considerations when grouping data include the volume of the data available, the credibility of the data available, the homogeneity of the risks in each cohort, and both settlement and payment pattern consistency. We use this data to determine historical claim reporting and payment patterns which are used in the analysis of ultimate claim liabilities. For portions of the business without sufficiently large numbers of policies or that have not accumulated sufficient historical statistics, our own data is supplemented with external or industry average data as available and when appropriate. For our executive products and marine business, we utilize external data extensively.

In addition to the review of historical claim reporting and payment patterns, we also incorporate an estimate of expected losses relative to premium by year into the analysis. The expected losses are based on a review of historical loss performance, trends in frequency and severity, and price level changes. The estimation of expected losses is subject to judgment including consideration given to internal and industry data available, growth and policy turnover, changes in policy limits, changes in underlying policy provisions, changes in legal and regulatory interpretations of policy provisions, and changes in reinsurance structure.

We use historical development patterns, estimations of the expected loss ratios, and standard actuarial methods to derive an estimate of the ultimate level of loss and LAE payments necessary to settle all the claims occurring as of the end of the evaluation period. Once an estimate of the ultimate level of claim payments has been derived, the amount of paid loss and LAE and case reserve through the evaluation date is subtracted to reveal the resulting level of IBNR.

Our reserve processes include multiple standard actuarial methods for determining estimates of IBNR reserves. Other supplementary methodologies are incorporated as deemed necessary. Mass tort and latent liabilities are examples of exposures where supplementary methodologies are used. Each method produces an estimate of ultimate loss by accident year. We review all of these various estimates and the actuaries assign weight to each based on the characteristics of the product being reviewed. The result is a single actuarial point estimate by product, by accident year.

The methodologies we have chosen to incorporate are a function of data availability and appropriately reflective of our own book of business. There are a number of additional actuarial methods that are available but are not currently being utilized because of data constraints or because the methods were either deemed redundant or not predictive for our book of business. From time to time, we evaluate the need to add supplementary methodologies. New methods are incorporated if it is believed that they improve the estimate of our ultimate loss and LAE liability. All of the actuarial methods tend to converge to the same estimate as an accident year matures. Our core methodologies are listed

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below with a short description and their relative strengths and weaknesses:

Paid Loss Development Historical payment patterns for prior claims are used to estimate future payment patterns for current claims. These patterns are applied to current payments by accident year to yield expected ultimate loss.

Strengths: The method reflects only the claim dollars that have been paid and is not subject to case-basis reserve changes or changes in case reserve practices.

Weaknesses: External claims environment changes can impact the rate at which claims are settled and losses paid (e.g., increase in attorney involvement or legal precedent). Adjustments to reflect changes in payment patterns on a prospective basis are difficult to quantify. For losses that have occurred recently, payments can be minimal and thus early estimates are subject to significant instability.

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Incurred Loss Development Historical case-incurred patterns (paid losses plus case reserves) for past claims are used to estimate future case-incurred amounts for current claims. These patterns are applied to current case-incurred losses by accident year to yield an expected ultimate loss.

Strengths: Losses are reported more quickly than paid, therefore, the estimates stabilize sooner. The method reflects more information (claims department case reserve) in the analysis than the paid loss development method.

Weaknesses: Method involves additional estimation risk if significant changes to case reserving practices have occurred.

Case Reserve Development Patterns of historical development in reported losses relative to historical case reserves are determined. These patterns are applied to current case reserves by accident year and the result is combined with paid losses to yield an expected ultimate loss.

Strengths: Like the incurred development method, this method benefits from using the additional information available in case reserves that is not available from paid losses only. It also can provide a more reasonable estimate than other methods when the proportion of claims still open for an accident year is unusually high or low.

Weaknesses: It is subject to the risk of changes in case reserving practices or philosophy. It may provide unstable estimates when an accident year is immature and more of the IBNR is expected to come from unreported claims rather than development on reported claims.

Expected Loss Ratio Historical loss ratios, in combination with projections of frequency and severity trends as well as estimates of price and exposure changes, are analyzed to produce an estimate of the expected loss ratio for each accident year. The expected loss ratio is then applied to the earned premium for each year to estimate the expected ultimate losses. The current accident year expected loss ratio is also used as the input in the determination of the prospective loss and ALAE ratio used in our initial IBNR generation process.

Strengths: Reflects an estimate independent of how losses are emerging on either a paid or a case reserve basis. Method is particularly useful in the absence of historical development patterns or where losses take a long time to emerge.

Weaknesses: Ignores how losses are actually emerging and thus produces the same estimate of ultimate loss regardless of favorable/unfavorable emergence.

Paid and Incurred Bornhuetter/Ferguson (BF) This approach blends the expected loss ratio method with either the paid or incurred loss development method. In effect, the BF methods produce weighted average indications for each accident year. As an example, if the current accident year for commercial automobile liability is estimated to be 20 percent paid, then the paid loss development method would receive a weight of 20 percent, and the expected loss ratio method would receive an 80 percent weight. Over time, this method will converge with the ultimate estimated in the respective loss development method.

Strengths: Reflects actual emergence that is favorable/unfavorable, but assumes remaining emergence will continue as previously expected. Does not overreact to the early emergence (or lack of emergence) where patterns are most unstable.

Weaknesses: Could potentially understate favorable or unfavorable development by putting some weight on the expected loss ratio.

In most cases, multiple estimation methods will be valid for the particular facts and circumstances of the claim liabilities being evaluated. Each estimation method has its own set of assumption variables and its own advantages and disadvantages, with no single estimation method being better than the others in all situations and no one set of assumption variables being meaningful for all product line components. The relative strengths and weaknesses of the particular estimation methods, when applied to a particular group of claims, can also change over time; therefore, the weight given to each estimation method will likely change by accident year and with each evaluation.

The actuarial point estimates typically follow a progression that places significant weight on the BF methods when accident years are younger and claims emergence is immature. As accident years mature and claims emerge over time, increasing weight is placed on the incurred development method, the paid development method, and the case reserve development method. For product lines with faster loss emergence, the progression to greater weight on the incurred and paid development methods occurs more quickly.

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For our long- and medium-tail products, the BF methods are typically given the most weight for the first 36 months of evaluation. These methods are also predominant for the first 12 months of evaluation for short-tail lines. Beyond these time periods, our actuaries apply their professional judgment when weighting the estimates from the various methods deployed.

Judgment can supersede this natural progression if risk factors and assumptions change, or if a situation occurs that amplifies a particular strength or weakness of a methodology. Extreme projections are critically analyzed and may be adjusted, given less credence, or discarded all together. Internal documentation is maintained that records any substantial changes in methods or assumptions from one loss reserve study to another.

Our estimates of ultimate loss and LAE reserves are subject to change as additional data emerges. This could occur as a result of change in loss development patterns, a revision in expected loss ratios, the emergence of exceptional loss activity, a change in weightings between actuarial methods, the addition of new actuarial methodologies or new information that merits inclusion, or the emergence of internal variables or external factors that would alter our view.

There is uncertainty in the estimates of ultimate losses. Significant risk factors to the reserve estimate include, but are not limited to, unforeseen or unquantifiable changes in:

- loss payment patterns,

- loss reporting patterns,

- frequency and severity trends,

- underlying policy terms and conditions,

- business or exposure mix,

- operational or internal process changes affecting timing of recording transactions,

- regulatory and legal environment, and/or

- economic environment.

Our actuaries engage in discussions with senior management, underwriting, and the claims department on a regular basis to attempt to ascertain any substantial changes in operations or other assumptions that are necessary to consider in the reserving analysis.

A considerable degree of judgment in the evaluation of all these factors is involved in the analysis of reserves. The human element in the application of judgment is unavoidable when faced with material uncertainty. Different experts will choose different assumptions when faced with such uncertainty, based on their individual backgrounds, professional experiences, and areas of focus. Hence, the estimate selected by various qualified experts may differ materially from each other. We consider this uncertainty by examining our historic reserve accuracy and through an internal peer review process.

Given the substantial impact of the reserve estimates on our financial statements, we subject the reserving process to significant diagnostic testing and reasonability checks. We have incorporated data validity checks and balances into our front-end processes. Data anomalies are researched and explained to reach a comfort level with the data and results. Leading indicators such as actual versus expected emergence and other diagnostics are also incorporated into the reserving processes.

Determination of Our Best Estimate

Upon completion of our full loss and LAE estimation analysis, the results are discussed with the LRC. As part of this discussion, the analysis supporting an indicated point estimate of the IBNR loss reserve by product is reviewed. The actuaries also present explanations supporting any changes to the underlying assumptions used to calculate the indicated point estimate. Quarterly, we also consider the actual loss emergence as compared to the expected loss emergence derived from the last full loss and LAE analyses. A review of the resulting variance between the indicated reserves and the carried reserves determined from the initial IBNR generation process takes place. After discussion of these analyses and all relevant risk factors, the LRC determines whether the reserve balances require adjustment.

As a predominantly excess and surplus lines and specialty insurer servicing niche markets, we believe there are several reasons to carry on an overall basis reserves above the actuarial point estimate. We believe we are subject to above average variation in estimates and that this variation is not symmetrical around the actuarial point estimate.

One reason for the variation is the above-average policyholder turnover and changes in the underlying mix of exposures typical of an excess and surplus lines business. This constant change can cause estimates based on prior experience to be less reliable than estimates for more stable, admitted books of business. Also, as a niche market writer, there is little industry-level information for direct comparisons of current and prior experience and other reserving parameters. These unknowns create greater-than-average variation in the actuarial point estimates.

Actuarial methods attempt to quantify future events. Insurance companies are subject to unique exposures that are difficult to foresee at the point coverage is initiated and, often, many years subsequent. Judicial and regulatory bodies involved in interpretation of insurance contracts have increasingly found opportunities to expand coverage beyond that which was intended or contemplated at the time the policy was issued. Many of these policies are issued on an all risk and occurrence basis. Aggressive plaintiff attorneys have often sought coverage beyond the insurer's original intent. Some examples would be the industry's ongoing asbestos and environmental litigation, court interpretations of exclusionary language on mold and construction defect, and debates over wind versus flood as the cause of loss from major hurricane events.

We believe that because of the inherent variation and the likelihood that there are unforeseen and under-quantified liabilities absent from the actuarial estimate, it is prudent to carry loss reserves above the actuarial point estimate. Most of our variance between the carried reserve and the actuarial point estimate is in the most recent accident years for our casualty segment where the most significant estimation risks reside. These estimation risks are considered when setting the initial loss ratio for the product and segment. In the cases where these risks fail to materialize, favorable loss development will likely occur over subsequent accounting periods. It is also possible that the risks materialize above the amount we considered when booking our initial loss reserves. In this case, unfavorable loss development is likely to occur over subsequent accounting periods.

Our best estimate of our loss and LAE reserves may change depending on a revision in the actuarial point estimate, the actuary's certainty in the estimates and processes, and our overall view of the underlying risks. From time to time, we benchmark our reserving policies and procedures and refine them by adopting industry best practices where appropriate. A detailed, ground-up analysis of the actuarial estimation risks associated with each of our products and segments, including an assessment of industry information, is performed annually.

Loss reserve estimates are subject to a high degree of variability due to the inherent uncertainty of ultimate settlement values. Periodic adjustments to these estimates will likely occur as the actual loss emergence reveals itself over time. We believe our loss reserving processes reflect industry best practices and our methodologies result in a reasonable provision for reserves as of December 31, 2008.

Reserve Sensitivities

There are three major parameters that have significant influence on our actuarial estimates of ultimate liabilities by product. They are the actual losses that are reported, the expected loss emergence pattern, and the expected loss ratios used in the analyses. If the actual losses reported do not emerge as expected, it may cause us to challenge all or some of our previous assumptions. We may change expected loss emergence patterns, the expected loss ratios used in our analysis, and/or the weights we place on a given actuarial method. The impact will be much greater and more leveraged for products with longer emergence patterns. Our general liability product is an example of a product with a relatively long emergence pattern. We have constructed a chart below that illustrates the sensitivity of our general liability reserve estimates for these key parameters. We believe the scenarios to be reasonable as similar favorable variations have occurred in recent years. In particular, our actual general liability loss emergence in 2008 was very favorable. The numbers below are the resulting change in estimated ultimate loss and ALAE in millions of dollars as of December 31, 2008 as a result of the change in the parameter shown.

| (in millions) | Result from favorable change in parameter | Result from unfavorable change in the parameter |
|--|--|--|
| +/-5 point change in expected loss ratio for all accident years | \$ (16.4) | \$ 16.4 |
| +/-10% change in expected emergence patterns | \$ (6.6) | \$ 6.2 |
| +/-25% change in actual loss emergence over a calendar year | \$ (13.1) | \$ 13.2 |
| Simultaneous change in expected loss ratio (5pts), expected emergence patterns (10%), and actual loss emergence (25%). | \$ (35.2) | \$ 36.4 |

There are often significant inter-relationships between our reserving assumptions that have offsetting or compounding effects on the reserve estimate. Thus, in almost all cases, it is impossible to discretely measure the effect of a single assumption or construct a meaningful sensitivity expectation that holds true in all cases. The scenario above is representative of general liability, one of our largest, and longest-tailed, products. It is unlikely that all of our products would have variations as wide as illustrated in the example. It is also unlikely that all of our products would simultaneously experience favorable or unfavorable loss development in the same direction or at their extremes during a calendar year. Because our portfolio is made up of a diversified mix of products, there would ordinarily be some offsetting favorable and unfavorable emergence by product as actual losses start to emerge and our loss estimates become more refined.

It is difficult for us to predict whether the favorable loss development observed in 2006 through 2008 will continue for any of our products in the future. We have reviewed historical data detailing the development of our total balance sheet reserves for each of the last 10 years. Based on this analysis and our understanding of loss reserve uncertainty, we believe fluctuations will occur in our estimate of ultimate reserve liabilities over time. Over the next calendar year, given our current exposure level and product mix, it would be reasonably likely for us to observe loss reserve development relating to prior years' estimates across all of our products ranging from approximately 8 percent (\$65 million) favorable to 4 percent (\$32 million) unfavorable.

Historical Loss and LAE Development

The table which follows is a reconciliation of our unpaid losses and settlement expenses (LAE) for the years 2008, 2007, and 2006.

| (Dollars in thousands) | Year Ended December 31, | | |
|---|-------------------------|--------------|--------------|
| | 2008 | 2007 | 2006 |
| Unpaid losses and LAE at beginning of year: | | | |
| Gross | \$ 1,192,178 | \$ 1,318,777 | \$ 1,331,866 |
| Ceded | (417,250) | (525,671) | (593,209) |
| Net | \$ 774,928 | \$ 793,106 | \$ 738,657 |
| Increase (decrease) in incurred losses and LAE: | | | |
| Current accident year | \$ 309,512 | \$ 296,047 | \$ 300,292 |
| Prior accident years | (62,338) | (105,179) | (43,403) |
| Total incurred | \$ 247,174 | \$ 190,868 | \$ 256,889 |
| Loss and LAE payments for claims incurred: | | | |
| Current accident year | \$ (51,599) | \$ (46,598) | \$ (47,994) |
| Prior accident years | (161,476) | (162,448) | (154,446) |
| Total paid | \$ (213,075) | \$ (209,046) | \$ (202,440) |
| Net unpaid losses and LAE at end of year | \$ 809,027 | \$ 774,928 | \$ 793,106 |
| Unpaid losses and LAE at end of year: | | | |
| Gross | \$ 1,159,311 | \$ 1,192,178 | \$ 1,318,777 |
| Ceded | (350,284) | (417,250) | (525,671) |
| Net | \$ 809,027 | \$ 774,928 | \$ 793,106 |

The deviations from our initial reserve estimates appeared as changes in our ultimate loss estimates as we updated those estimates through our reserve analysis process. The recognition of the changes in initial reserve estimates occurred over time as claims were reported, initial case reserves were established, initial reserves were reviewed in light of additional information, and ultimate payments were made on the collective set of claims incurred as of that evaluation date. The new information on the ultimate settlement value of claims is therefore continually updated and revised as this process takes place until all claims in a defined set of claims are settled. As a relatively small insurer, our experience will ordinarily exhibit fluctuations from period to period. While we attempt to identify and react to systematic changes in the loss environment, we also must consider the volume of experience directly available to us, and interpret any particular period's indications with a realistic technical understanding of the reliability of those observations.

The table below summarizes our prior accident years' loss reserve development by segment for 2008, 2007, and 2006:

| (in thousands) | 2008 | 2007 | 2006 |
|---|-------------|--------------|-------------|
| (Favorable)/Unfavorable reserve development by segment | | | |
| Casualty | \$ (50,562) | \$ (87,397) | \$ (40,030) |
| Property | (6,646) | (6,690) | (1,784) |
| Surety | (5,130) | (11,092) | (1,589) |
| Total | \$ (62,338) | \$ (105,179) | \$ (43,403) |

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A discussion of significant components of reserve development for the three most recent calendar years follows:

2008. During 2008, we experienced favorable loss emergence from prior years' reserve estimates across all of our segments. For our casualty segment, we experienced \$50.6 million of favorable development, predominantly from the accident years of 2002-2006. In retrospect, the expected loss ratios initially used to set booked reserves for these accident years have proven to be conservative, which has resulted in loss emergence significantly lower than expected. This is particularly true for our general liability, personal umbrella, and commercial umbrella products which experienced favorable loss development of \$33.1 million, \$12.7 million, and \$11.8 million, respectively. The construction class was the largest contributor to the favorable emergence in the general liability product. In addition, our program business experienced \$9.3 million of unfavorable prior years' loss development during the year, mostly isolated in accident years 2004-2007. Our experience in the liquor liability class has been particularly adverse. In the past, we relied on external loss development patterns that have not

proven predictive of actual emergence. As a result, this class is being re-underwritten and we implemented a more stringent reserving approach in 2008.

Our property segment realized \$6.6 million of favorable loss development in 2008. Most of this emergence was in accident years 2005-2007. The construction and fire products were the drivers of the favorable emergence recording \$4.4 million and \$4.2 million, respectively. The construction business has been in run-off for three years and recent experience has been much better than expected with a significant reduction in both frequency and severity of claims. Only a handful of contracts remain open and we have observed little new activity from this product line. Our fire product saw significant favorable emergence from the 2007 accident year, as our year-end 2007 reserves have developed more favorably than originally estimated.

Our surety segment experienced \$5.1 million of favorable emergence. Almost all of the favorable emergence is from the 2007 accident year. Very little observed loss severity in the commercial surety product resulted in \$1.7 million of favorable emergence. Continued improvement in our contract surety loss ratio resulting from past re-underwriting of the business led to \$2.5 million of favorable loss reserve development.

2007. We periodically review our loss reserve estimates and underlying actuarial reserving methodologies in order to assess their accuracy and suitability, and to benchmark our reserving practices against industry best practices. A detailed assessment of recent trends and reserve risk factors was undertaken in 2007. As part of our reviews, we performed a more detailed, ground-up analysis of the actuarial estimation risks associated with each of our products and segments, including an assessment of industry information.

Our analyses also revealed that our quarterly actuarial reserve estimates over recent historical periods had shown a downward trend as a result of a moderating loss trend environment, improvements in policy terms and conditions and a favorable underlying exposure mix that occurred during the hard market period from 2001 through 2004.

Based on this review, we made certain refinements to our reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves through increased internal dialogue among the claim, underwriting, risk management and actuarial departments, greater transparency of the actuarial process and results, and improved reserving diagnostics. Overall, these enhancements and improved information provide better and faster feedback to management regarding loss development resulting in greater overall confidence in the actuarial estimates. This and the increased stability in our business in the last few years diminished the needed level of carried reserves above the actuarial point estimate. We believe that these reserve methodology enhancements improved the overall accuracy of our best estimate of loss and LAE reserves. Over half of the favorable prior years loss development was the result of this detailed assessment and resulting changes in our booked reserves.

Our casualty segment was most impacted by prior years loss development realizing a total of \$87.4 million of favorable emergence. All casualty products were impacted by the enhanced risk assessment previously mentioned. Our general liability, transportation, personal umbrella, and professional liability products realized favorable development of \$42.5 million, \$19.6 million, \$10.5 million, and \$8.1 million, respectively. This favorable emergence was concentrated in accident years 2004-2006. As a result of significant favorable loss development observed over the past several years for our general liability product, we reassessed the expected loss ratios used in our actuarial analysis and subsequently lowered them for the construction classes. For our transportation and personal umbrella products, we reassessed and subsequently lowered the loss development factors in our analysis reflecting our observation that the emergence patterns were more favorable than previously anticipated. Finally, our professional liability products realized actual loss emergence much more favorably than expected.

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The property segment realized \$6.7 million of favorable prior years' development. The favorable emergence was realized across almost all of our property products, predominantly in accident years 2005 and 2006. We also executed a favorable reinsurance commutation impacting accident years prior to 2000.

The surety segment realized \$11.1 million of favorable prior years' development. Almost all of the development was the result of the risk reassessment and reflection of significantly lower reserve risk after achieving settlement with the larger banks involved in the CMC litigation (see note 10 to our audited consolidated financial statements included in our 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein, for more details).

2006. During 2006, we continued to experience favorable loss development and a reduction in prior years' loss reserve estimates. Pricing increased substantially and policy terms and conditions became more favorable for most of our products during the 2001-2004 policy years. Many of the improvements in market conditions were difficult to quantify at the time of the original estimate. Our significant growth in premium and exposures made precise quantification of these changes even more challenging. In 2006, losses continued to emerge on the prior accident years much more favorably than we expected.

when making our original estimates. We experienced favorable development of \$43.4 million in aggregate on prior years' estimates.

Of this decrease to prior years' loss reserve estimates, approximately \$40.0 million occurred in the casualty segment. The development is primarily from our general liability, executive products liability, and employer's indemnity products. In our general liability product we experienced \$25.4 million of favorable development. Most of this development came from the 2004 and 2005 accident years. As part of our normal reserving process, we reviewed the expected loss ratios used in several of our reserving methods. This review confirmed the favorable emergence from 2002-2005 accident years. As a result of this study, the expected loss ratios were reduced for 2004-2006 with the most significant change occurring to the 2005 accident year. Approximately \$15.4 million of the favorable general liability development can be attributed to this update in expected loss ratios. The remaining portion of the decrease in prior years' loss reserve estimate was the result of the continued favorable loss emergence and the natural progression of shifting more weight to our incurred and paid development methods as accident years get older. In our executive products liability business, we experienced \$7.4 million of favorable development. Most of this change can be attributed to accident years 2001, 2003, and 2004. The estimates improved as a result of lower than expected loss severity in those accident years. For our employer's indemnity product, we experienced \$5.7 million of favorable development. We experienced significantly less loss emergence than expected for accident years prior to 2003 and benefited from favorable settlements on several claims in accident years 2001-2003.

Overall, our property and surety segments experienced relatively small changes in prior years' estimates of reserves. However, we experienced \$4.2 million of favorable development from 2004 and 2005 hurricane estimates. We also saw \$7.2 million of unfavorable development on our construction product that is in runoff. Most of this development came from accident years 2002-2005. The construction emergence pattern revealed itself to be longer than originally anticipated and has not behaved consistent with reporting patterns expected from a property segment. We do not anticipate any further significant deterioration in our estimates.

The following table presents the development of our balance sheet reserves from 1998 through 2008. The top line of the table shows the net reserves at the balance sheet date for each of the indicated periods. This represents the estimated amount of net losses and settlement expenses arising in all prior years that are unpaid at the balance sheet date, including losses that had been incurred but not yet reported to us. The lower portion of the table shows the re-estimated amount of the previously recorded gross and net reserves based on experience as of the end of each succeeding year. The estimate changes as more information becomes known about the frequency and severity of claims for individual periods.

Adverse loss and LAE reserve development can be observed in the table for years ending 1999-2002 on a net basis, and 1999-2003 on a gross basis. This development is related to unexpectedly large increases in loss frequency and severity and unquantifiable expansion of policy terms and conditions that took place in accident years 1997-2001 for our casualty segment. These causes widely impacted the property and casualty insurance industry during this time as soft market conditions were prevalent. These factors, combined with our rapid growth during 1999-2002, caused significant estimation risk, and thus had a related impact on our reserve liabilities for those years.

As the table displays, variations exist between our cumulative loss experience on a gross and net basis, due to the application of reinsurance. On certain products, our net retention (after applying reinsurance) is significantly less than our gross retention (before applying reinsurance). These differences in retention can cause a significant (leveraged) difference between loss reserve development on a net and gross basis. Additionally, the relationship of our gross to net retention changes over time. For example, we changed underwriting criteria to increase gross retentions (gross policy limits) on certain products written in 1999 through 2001, while leaving net retention unchanged. These products contained gross retentions of up to \$50.0 million, while the relating net retention remained at \$0.5 million. Loss severity on certain of these products exceeded original expectations. As shown in the table that follows, on a re-estimated basis, this poor loss experience resulted in significant indicated gross deficiencies, with substantially less deficiency indicated on a net basis, as many losses were initially recorded at their full net retention. In 2002, we reduced our gross policy limits on many of these products to \$15.0 million, while net retention increased to \$1.0 million. As the relationship of our gross to net retention changes over time, re-estimation of loss reserves will result in variations between our cumulative loss experience on a gross and net basis.

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| (Dollars in thousands) | Year Ended December 31, | | | | | | | | | | |
|---|-------------------------|------------|-------------|-------------|-------------|------------|------------|------------|------------|------------|------------|
| | 1998 & Prior | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
| Net Liability for unpaid losses and Settlement expenses at end of the year | \$ 247,262 | \$ 274,914 | \$ 300,054 | \$ 327,250 | \$ 391,952 | \$ 531,393 | \$ 668,419 | \$ 738,657 | \$ 793,106 | \$ 774,928 | \$ 809,027 |
| Paid cumulative as of: | | | | | | | | | | | |
| One year later | 53,892 | 65,216 | 92,788 | 98,953 | 94,465 | 129,899 | 137,870 | 154,446 | 162,448 | 161,484 | |
| Two years later | 88,567 | 113,693 | 155,790 | 159,501 | 182,742 | 212,166 | 239,734 | 270,210 | 275,322 | | |
| Three years later | 114,465 | 149,989 | 192,630 | 211,075 | 234,231 | 273,019 | 324,284 | 353,793 | | | |
| Four years later | 132,796 | 172,443 | 222,870 | 238,972 | 269,446 | 322,050 | 378,417 | | | | |
| Five years later | 145,888 | 191,229 | 237,464 | 260,618 | 300,238 | 357,239 | | | | | |
| Six years later | 159,153 | 200,610 | 250,092 | 281,775 | 321,841 | | | | | | |
| Seven years later | 165,277 | 209,288 | 261,612 | 295,663 | | | | | | | |
| Eight years later | 171,709 | 216,934 | 272,692 | | | | | | | | |
| Nine years later | 176,310 | 225,414 | | | | | | | | | |
| Ten years later | 182,751 | | | | | | | | | | |
| Liability re-estimated as of: | | | | | | | | | | | |
| One year later | 243,270 | 273,230 | 309,021 | 340,775 | 393,347 | 520,576 | 605,946 | 695,254 | 687,927 | 712,590 | |
| Two years later | 233,041 | 263,122 | 301,172 | 335,772 | 394,297 | 485,146 | 577,709 | 636,356 | 637,117 | | |
| Three years later | 229,750 | 263,639 | 314,401 | 344,668 | 397,772 | 478,113 | 566,181 | 599,420 | | | |
| Four years later | 217,476 | 262,156 | 319,923 | 355,997 | 409,597 | 490,022 | 549,795 | | | | |
| Five years later | 207,571 | 264,383 | 323,698 | 359,161 | 424,809 | 483,575 | | | | | |
| Six years later | 205,563 | 264,569 | 323,642 | 377,264 | 422,027 | | | | | | |
| Seven years later | 204,002 | 264,305 | 340,498 | 379,229 | | | | | | | |
| Eight years later | 204,597 | 280,666 | 342,024 | | | | | | | | |
| Nine years later | 219,304 | 281,020 | | | | | | | | | |
| Ten years later | 219,987 | | | | | | | | | | |
| Net cumulative redundancy (deficiency) | \$ 27,275 | \$ (6,106) | \$ (41,970) | \$ (51,979) | \$ (30,075) | \$ 47,818 | \$ 118,624 | \$ 139,237 | \$ 155,989 | \$ 62,338 | |

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| | | | | | | | | | | | |
|---|------------|-------------|--------------|--------------|--------------|-------------|--------------|--------------|--------------|--------------|--------------|
| Gross liability | \$ 415,523 | \$ 520,494 | \$ 539,750 | \$ 604,505 | \$ 732,838 | \$ 903,441 | \$ 1,132,599 | \$ 1,331,866 | \$ 1,318,777 | \$ 1,192,178 | \$ 1,159,311 |
| Reinsurance recoverable | (168,261) | (245,580) | (239,696) | (277,255) | (340,886) | (372,048) | (464,180) | (593,209) | (525,671) | (417,250) | (350,284) |
| Net liability | \$ 247,262 | \$ 274,914 | \$ 300,054 | \$ 327,250 | \$ 391,952 | \$ 531,393 | \$ 668,419 | \$ 738,657 | \$ 793,106 | \$ 774,928 | \$ 809,027 |
| Gross re-estimated liability | \$ 387,150 | \$ 616,296 | \$ 779,665 | \$ 789,187 | \$ 878,016 | \$ 924,595 | \$ 965,990 | \$ 1,033,667 | \$ 964,343 | \$ 1,038,429 | |
| Re-estimated recoverable | (167,163) | (335,276) | (437,641) | (409,958) | (455,989) | (441,020) | (416,195) | (434,247) | (327,226) | (325,839) | |
| Net re-estimated liability | \$ 219,987 | \$ 281,020 | \$ 342,024 | \$ 379,229 | \$ 422,027 | \$ 483,575 | \$ 549,795 | \$ 599,420 | \$ 637,117 | \$ 712,590 | |
| Gross cumulative redundancy (deficiency) | \$ 28,373 | \$ (95,802) | \$ (239,915) | \$ (184,682) | \$ (145,178) | \$ (21,154) | \$ 166,609 | \$ 298,199 | \$ 354,434 | \$ 153,749 | |

Operating Ratios***Premiums to Surplus Ratio***

The following table shows, for the periods indicated, our insurance subsidiaries' statutory ratios of net premiums written to policyholders' surplus. While there is no statutory requirement applicable to us that establishes a permissible net premiums written to surplus ratio, guidelines established by the National Association of Insurance Commissioners, or NAIC, provide that this ratio should generally be no greater than 3 to 1. While the NAIC provides this general guideline, rating agencies often require a more conservative ratio to maintain strong or superior ratings.

| (Dollars in thousands) | Year Ended December 31, | | | | | |
|--------------------------------|-------------------------|------------|------------|------------|------------|--|
| | 2008 | 2007 | 2006 | 2005 | 2004 | |
| Statutory net premiums written | \$ 513,456 | \$ 538,763 | \$ 551,536 | \$ 494,565 | \$ 511,212 | |
| Policyholders' surplus | 678,041 | 752,004 | 746,905 | 690,547 | 605,967 | |
| Ratio | 0.8 to 1 | 0.7 to 1 | 0.7 to 1 | 0.7 to 1 | 0.8 to 1 | |

GAAP and Statutory Combined Ratios

Our underwriting experience is best indicated by our GAAP combined ratio, which is the sum of (a) the ratio of incurred losses and settlement expenses to net premiums earned (loss ratio) and (b) the ratio of policy acquisition costs and other operating expenses to net premiums earned (expense ratio).

| GAAP | Year Ended December 31, | | | | | |
|----------------|-------------------------|------|------|------|------|--|
| | 2008 | 2007 | 2006 | 2005 | 2004 | |
| Loss ratio | 46.7 | 35.1 | 48.4 | 51.1 | 59.9 | |
| Expense ratio | 37.5 | 36.3 | 35.7 | 34.9 | 32.3 | |
| Combined ratio | 84.2 | 71.4 | 84.1 | 86.0 | 92.2 | |

We also calculate the statutory combined ratio, which is not indicative of GAAP underwriting income due to accounting for policy acquisition costs differently for statutory accounting purposes compared to GAAP. The statutory combined ratio is the sum of (a) the ratio of statutory loss and settlement expenses incurred to statutory net premiums earned (loss ratio) and (b) the ratio of statutory policy acquisition costs and other underwriting expenses to statutory net premiums written (expense ratio).

| Statutory | Year Ended December 31, | | | | | |
|------------|-------------------------|------|------|------|------|--|
| | 2008 | 2007 | 2006 | 2005 | 2004 | |
| Loss ratio | 46.7 | 35.1 | 48.4 | 51.1 | 59.9 | |

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| | | | | | |
|-------------------------|----------|---------|---------|----------|---------|
| Expense ratio | 39.0 | 38.2 | 35.6 | 35.6 | 33.9 |
| Combined ratio | 85.7 | 73.3 | 84.0 | 86.7 | 93.8 |
| Industry combined ratio | 104.0(1) | 95.5(2) | 92.4(2) | 101.2(2) | 98.9(2) |

(1) Source: Standard & Poor's RatingsDirect. Estimated for the year ended December 31, 2008.

(2) Source: A.M. Best Aggregate & Averages Property-Casualty (2008 Edition) statutory basis.

Investments

Oversight of our investment policies is conducted by our board of directors and officers. We follow an investment policy that is reviewed quarterly and revised periodically.

Our investment portfolio serves primarily as the funding source for loss reserves and secondly as a source of income and appreciation. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. Investments of the highest quality and marketability are critical for preserving our claims-paying ability. Common stock investments are limited to securities listed on the national exchanges and rated by the Securities Valuation Office of the NAIC. Our portfolio contains no derivatives or off-balance sheet structured investments. In addition, we employ stringent diversification rules and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite fluctuations of realized and unrealized gains and losses in the equity portfolio, our investment in equity securities as part of a long-term asset allocation strategy has contributed significantly to our historic growth in book value.

Our investments include fixed income debt securities, common stock equity securities, preferred stock equity securities, exchange traded funds (ETFs) and a high-yield municipal bond mutual fund. Effective January 1, 2008, we determined the fair values of certain financial instruments based on the fair value hierarchy established in SFAS 157. SFAS 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: quoted price (unadjusted) in active markets for identical assets

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument

Level 3: inputs to the valuation methodology are unobservable for the asset or liability

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

To measure fair value, we obtain quoted market prices for our investment securities. If a quoted market price is not available, we use quoted market prices of similar securities.

Assets measured at fair value on a recurring basis are summarized below:

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| (in thousands) Description | As of December 31, 2008, Fair Value Measurements Using | | | Total |
|----------------------------------|---|--|--|---------------------|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Trading securities | \$ | \$ | 10,020 | \$ 10,020 |
| Available-for-sale securities | | 286,790 | 1,224,215 | 1,511,005 |
| Total | \$ | 286,790 | \$ 1,234,235 | \$ 1,521,025 |

As noted in the above table, we did not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2008.

We continuously monitor the values of our investments in fixed income securities and equity securities for other-than-temporary impairment. If this review suggests that a decline in fair value is other-than-temporary based upon many factors including the duration or significance of the unrealized loss, our carrying value in the investment is reduced to its fair value through an adjustment to earnings. In 2008, we recorded impairment losses totaling \$76.2 million. This was comprised of \$12.0 million in our fixed income portfolio and \$64.2 million in our equity portfolio.

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The fixed income portfolio contained 229 unrealized loss positions as of December 31, 2008. The \$31.3 million in associated unrealized losses for these 229 securities is 2.4 percent of the fixed income portfolio's cost basis. Of these 229 securities, 33 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent \$9.5 million in unrealized losses. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. With respect to those fixed income securities which fall under the provisions of *EITF 99-20: Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests that Continue to be Held by a Transferor in Securitized Financial Assets*, all of our securitized financial assets are of a high credit quality and it is not probable that contractual cash flows will not be collected. The fixed income unrealized losses can be primarily attributed to spreads widening in the corporate, municipal and mortgage backed security markets. We have the ability and intent to hold these securities to maturity. In addition, we continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. We consider price declines of securities in our other-than-temporary impairment analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

Factors that we consider in the evaluation of credit quality include:

1. Changes in technology that may impair the earnings potential of the investment,
2. Discontinuance of a segment of the business that may affect the future earnings potential,
3. Reduction or elimination of dividends,
4. Specific concerns related to the issuer's industry or geographic area of operation,
5. Significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
6. Downgrade in credit quality by a major rating agency.

As of December 31, 2008, we held 33 common stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled \$27.3 million. Of the 33 common stock positions that were in an unrealized loss position, one has been in an unrealized loss position for more than 12 consecutive months, representing \$4.2 million in unrealized losses. We specifically review equity securities with unrealized losses greater than 12 months in duration as to the financial condition and future prospects of the issuers and the price volatility of the equity securities themselves. At December 31, 2008, the one position in unrealized losses for greater than 12 months relates to an exchange traded mutual fund that is based on general market indices. However, we have observed that none of these securities have declined by 20 percent or more from their cost basis for a continuous period of six months or more. We believe all of these positions have favorable long-term prospects and we believe that all unrealized loss positions will recover to our cost basis in a reasonable period of time.

Fixed Income Securities

As of December 31, 2008, our fixed income portfolio had the following rating distributions:

| FAIR VALUE | AAA | AA | A | BBB | BB or Below | Fair Value |
|---|------------|------------|------------|------------|--------------------|-------------------|
| Bonds: | | | | | | |
| Corporate - financial | \$ 1,542 | \$ 5,118 | \$ 58,927 | \$ 12,803 | \$ 6 | \$ 78,396 |
| All other corporate | 1,595 | 1,755 | 120,795 | 48,755 | 2,959 | 175,859 |
| Financials - private placements | | | 1,619 | 7,894 | | 9,513 |
| All other corporates - private placements | | | 7,578 | 1,540 | | 9,118 |
| U.S. govt. agency (GSE) | 311,224 | 265 | | | | 311,489 |
| Tax-exempt municipal securities | 57,026 | 290,284 | 85,429 | 21,140 | | 453,879 |
| Structured: | | | | | | |
| GSE - RMBS | \$ 170,537 | \$ 2,024 | \$ | \$ | \$ | \$ 172,561 |
| Non-GSE RMBS - prime | | | | | | |
| Non-GSE RMBS - Alt A | | | | | | |
| Non-GSE RMBS - subprime | | | | | | |
| ABS - home equity | 2,529 | | | | | 2,529 |
| ABS - credit cards | 339 | | | | | 339 |
| ABS - auto loans | 3,646 | | | 153 | | 3,799 |
| All other ABS | 14,539 | | | | | 14,539 |
| CMBS | 43,635 | | | | | 43,635 |
| CDOs/CLOs | | | | | | |
| | \$ 606,612 | \$ 299,446 | \$ 274,348 | \$ 92,285 | \$ 2,965 | \$ 1,275,656 |

Our fixed income portfolio comprised 77 percent of our total 2008 portfolio, versus 75 percent of the total at December 31, 2007, and 74 percent of the total as of December 31, 2006. As of December 31, 2008, our fixed income portfolio contained 48 percent AAA-rated securities, 23 percent AA-rated securities, 22 percent A-rated securities, and 7 percent BBB-rated or lower securities.

As of December 31, 2008, the duration of the fixed income portfolio was 4.4 years. Our fixed income portfolio remained diversified with investments in treasury, government sponsored agency, corporate, municipal, mortgage-backed, and asset-backed securities. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. In selecting the maturity of securities in which we invest, we consider the relationship between the duration of our fixed income investments and the duration of our liabilities, including the expected ultimate payout patterns of our reserves. We believe that both liquidity and interest rate risk can be minimized by such asset/liability management.

Our mortgage-backed securities (MBS) portfolio is comprised of residential MBS investments. As of December 31, 2008, MBS investments totaled \$172.6 million (14 percent) of the fixed income portfolio compared to \$205.7 million (15 percent) as of December 31, 2007.

We believe MBS investments add diversification, liquidity, credit quality and additional yield to our portfolio. Our objective for the MBS portfolio is to provide reasonable cash flow stability and increased yield. This sector experienced unusually high volatility given the concerns over housing prices and general economic conditions. The MBS portfolio includes collateralized mortgage obligations (CMOs) and

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mortgage-backed pass-through securities. A mortgage pass-through is a security consisting of a pool of residential mortgage loans. All payments of principal and interest are passed through to investors each month. A CMO is a mortgage-backed security with a fixed maturity. This can eliminate the risks associated with prepayment because each security is divided into maturity classes that are paid off in order. Our MBS portfolio does not include interest-only securities, principal-only securities or other MBS investments which may exhibit extreme market volatility.

Our asset-backed securities (ABS) portfolio is comprised mostly of rate reduction utility bonds, among others. As of December 31, 2008, ABS/CMBS (commercial mortgage-backed securities) investments were \$64.8 million (5 percent) of the fixed income portfolio, compared to \$97.7 million (7 percent) as of December 31, 2007. CMBS made up

\$43.6 million (67 percent) of the ABS/CMBS portfolio compared to \$61.5 million (63 percent) at December 31, 2007. The entire CMBS portfolio was rated AAA as of December 31, 2008.

We define subprime mortgages as loans which include one or more of the following: a weak credit score (FICO score of less than 640), high debt-to-income ratio, high loan-to-value ratio, or undocumented income. Our exposure to subprime lending is limited to investments within the fixed income investment portfolio which contains securities collateralized by mortgages that have characteristics of subprime lending such as home equity mortgages. These investments are in the form of asset-backed securities collateralized by subprime mortgages and collateralized mortgage obligations backed by alternative documentation mortgages. The total carrying value of these investments is less than \$3 million comprising less than 1 percent of our total fixed income portfolio. The credit rating of all of these securities was AAA as of December 31, 2008 and reflects our practice of minimizing exposure to low quality (subprime type) credit risk. In addition, all of the securities containing subprime collateral were originated before 2005. We did not recognize any impairment write downs in the investment portfolio due to subprime mortgages during the periods presented herein.

We have a significant allocation to municipal fixed income securities. As of December 31, 2008, the municipal bond component of the fixed income portfolio decreased \$19.8 million, to \$453.9 million and comprised 36 percent of our total fixed income portfolio, versus 34 percent of the fixed income portfolio at year-end 2007.

We believe municipal fixed income securities provide diversification, liquidity, credit quality and additional yield to our portfolio. Our objective for the municipal fixed income portfolio is to provide reasonable cash flow stability and increased after tax yield. Our municipal fixed income portfolio is comprised of general obligation (GO) and revenue securities. The revenue sources include but are not limited to public improvement, school, transportation, colleges and universities, water and sewer.

As of December 31, 2008, approximately 55 percent of the municipal fixed income securities in the investment portfolio were GO and the remaining 45 percent were revenue fixed income. Seventy-six percent of our municipal fixed income securities were rated AA or better, while 95 percent were rated A or better. We believe our municipal fixed income portfolio has very high credit quality.

As of December 31, 2008, our corporate debt portfolio totaled \$272.9 million (21 percent) of the fixed income portfolio compared to \$232.1 million (17 percent) as of December 31, 2007. The corporate debt portfolio has an overall quality rating of single A, diversified amongst 102 issuers across 18 industries.

Corporate debt securities experienced large interest rate spread widening in 2008 as this market was directly impacted by the declining housing market, credit crisis and slowing economy. We believe corporate debt investments add diversification, liquidity and additional yield to our portfolio. With our high quality, diversified portfolio, the corporate debt investments will continue to be a significant part of our investment program and we believe it is probable that the securities in our portfolio will continue to receive contractual payments in the form of principal and interest.

During 2008, we allocated the majority of available cash flows to the purchase of fixed income securities. The mix of instruments within the portfolio is decided at the time of purchase on the basis of fundamental analysis and relative value. As of December 31, 2008, 93 percent of the fixed income portfolio was rated A or better and 71 percent was rated AA or better.

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We currently classify 3 percent of the securities in our fixed income portfolio as held-to-maturity, meaning they are carried at amortized cost and are intended to be held until their contractual maturity. Other portions of the fixed income portfolio are classified as available-for-sale (96 percent) or trading (1 percent) and are carried at fair value. As of December 31, 2008, we maintained \$1.2 billion in fixed income securities within the available-for-sale and trading classifications. The available-for-sale portfolio provides an additional source of liquidity and can be used to address potential future changes in our asset/liability structure.

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Aggregate maturities for the fixed-income portfolio as of December 31, 2008, are as follows:

| (thousands) | Par Value | Amortized Cost | Fair Value | Carrying Value |
|-------------|--------------|----------------|--------------|----------------|
| 2009 | \$ 28,320 | \$ 28,430 | \$ 28,725 | \$ 28,579 |
| 2010 | 32,225 | 32,690 | 32,635 | 32,586 |
| 2011 | 88,608 | 90,088 | 90,844 | 90,227 |
| 2012 | 67,443 | 68,616 | 70,091 | 69,928 |
| 2013 | 86,537 | 89,236 | 91,424 | 90,946 |
| 2014 | 74,598 | 78,023 | 78,888 | 78,851 |
| 2015 | 63,674 | 64,509 | 60,444 | 60,335 |
| 2016 | 41,840 | 42,895 | 41,900 | 41,900 |
| 2017 | 104,099 | 102,154 | 100,615 | 100,615 |
| 2018 | 159,138 | 160,340 | 157,255 | 157,254 |
| 2019 | 36,054 | 38,101 | 37,369 | 37,369 |
| 2020 | 38,932 | 39,990 | 39,779 | 39,779 |
| 2021 | 30,630 | 31,915 | 31,759 | 31,759 |
| 2022 | 94,937 | 95,699 | 94,979 | 94,979 |
| 2023 | 108,306 | 109,725 | 108,229 | 108,229 |
| 2024 | 7,791 | 8,029 | 7,957 | 7,957 |
| 2025 | 3,026 | 3,026 | 3,074 | 3,074 |
| 2026 | 0 | 0 | 0 | 0 |
| 2027 | 3,000 | 3,004 | 2,016 | 2,016 |
| 2028 | 7 | 7 | 7 | 7 |
| 2029 | 5 | 5 | 5 | 5 |
| 2030 | 6,489 | 6,502 | 5,609 | 5,609 |
| 2031 | 4,298 | 4,301 | 4,150 | 4,150 |
| 2032 | 7,687 | 7,755 | 7,806 | 7,806 |
| 2033 | 36,181 | 36,362 | 36,448 | 36,448 |
| 2034 | 17,506 | 17,587 | 17,621 | 17,621 |
| 2035 | 14,129 | 14,398 | 14,183 | 14,183 |
| 2036 | 40,368 | 40,403 | 40,809 | 40,809 |
| 2037 | 33,001 | 32,845 | 33,711 | 33,711 |
| 2038 | 17,886 | 17,814 | 17,596 | 17,596 |
| 2039 | 3,100 | 3,177 | 2,924 | 2,924 |
| 2040 | 8,000 | 7,931 | 7,000 | 7,000 |
| 2041 | 8,296 | 8,407 | 7,317 | 7,317 |
| 2042 | 200 | 200 | 158 | 158 |
| 2043 | 2,240 | 2,256 | 2,041 | 2,041 |
| 2044 | 0 | 0 | 0 | 0 |
| 2045 | 150 | 150 | 128 | 128 |
| 2046 | 115 | 109 | 84 | 84 |
| 2047 | 105 | 100 | 76 | 76 |
| 2048 | 0 | 0 | 0 | 0 |
| 2049 | 0 | 0 | 0 | 0 |
| 2050 | 0 | 0 | 0 | 0 |
| | \$ 1,268,921 | \$ 1,286,779 | \$ 1,275,656 | \$ 1,274,056 |

Equity Securities

At December 31, 2008, our equity securities were valued at \$286.8 million, a decrease of \$106.9 million from the \$393.7 million held at the end of 2007. During 2008, the pretax change in unrealized gains on equity securities was -\$102.6 million. Equity securities represented 17 percent of cash and invested assets at the end of 2008, a decrease from the 21 percent at year-end 2007. As of the year-end 2008, total equity investments held represented 41 percent of our shareholders' equity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. In addition, we have investments in real estate investment trusts, ETFs, preferred stocks, and a high-yield municipal bond fund. Our strategy remains one of value investing, with security selection taking precedence over market timing. A buy-and-hold strategy is used, minimizing both transaction costs and taxes. In 2008, we recorded impairment losses of \$64.2 million on our equity securities. The impairments were the result of our belief that the securities were not likely to recover in a reasonable period of time.

The following table illustrates the distribution by sector of our equity portfolio as of December 31, 2008, including fair value, cost basis, and unrealized gains and losses:

| (in thousands) | Cost Basis | 12/31/2008 Fair Value | % of Total Fair Value | Net Unrealized Gain/Loss |
|------------------------|-------------------|--------------------------|--------------------------|--------------------------------|
| Common stock: | | | | |
| Consumer discretionary | \$ 18,265 | \$ 14,700 | 5.1% | \$ (3,565) |
| Consumer staples | 11,492 | 22,113 | 7.7% | 10,621 |
| Energy | 11,171 | 22,181 | 7.7% | 11,010 |
| Financials | 17,549 | 20,406 | 7.1% | 2,857 |
| Healthcare | 10,395 | 18,439 | 6.4% | 8,044 |
| Industrials | 15,560 | 19,249 | 6.7% | 3,689 |
| Information technology | 13,005 | 14,807 | 5.2% | 1,802 |
| Materials | 4,329 | 3,284 | 1.2% | (1,045) |
| REITs | 4,771 | 4,833 | 1.7% | 62 |
| Telecommunications | 4,408 | 8,950 | 3.1% | 4,542 |
| Utilities | 41,980 | 52,495 | 18.3% | 10,515 |
| ETFs | 53,556 | 40,111 | 14.0% | (13,445) |
| High-yield muni fund | 33,341 | 33,341 | 11.6% | |
| Preferred stock | 11,461 | 11,881 | 4.2% | 420 |
| Total | \$ 251,283 | \$ 286,790 | 100% | \$ 35,507 |

As of December 31, 2008, our common stock portfolio totaled \$201.5 million (70 percent) of the equity portfolio compared to \$322.7 million (82 percent) as of December 31, 2007. The decline in value of our common stock portfolio in 2008 was primarily due to an investment decision to reduce our common stock exposure as well as a negative return in the asset class.

Our common stock portfolio consists largely of large cap, value oriented, dividend paying securities. We employ a long term, buy and hold strategy that has provided superior returns over the last 10 years. While we anticipate continued volatility, we believe an equity allocation provides certain diversification and return benefits over the long term. The strategy provides above-market dividend yields with less volatility than the market. The beta of our equity portfolio is 0.7.

In 2008, we added two ETFs to our equity portfolio. As of December 31, 2008, our ETF investment totaled \$40.1 million (14 percent) of the equity portfolio compared to \$2.6 million (1 percent) as of December 31, 2007. The ETF investments add diversification, liquidity and increased return potential to our portfolio. In 2008, the ETFs outperformed the overall market but still contributed to the negative performance of

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the equity portfolio. We believe that ETF securities will be an important part of our investment program going forward. Our current ETFs contain large-cap securities that match our overall equity investment philosophy of providing superior dividend yields with less volatility than the market. These ETFs track various indices and have returns for 2008 consistent with the benchmark indices they follow.

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As of December 31, 2008, our investment in preferred stock securities totaled \$11.9 million (4 percent) of the equity portfolio compared to \$34.2 million (9 percent) as of December 31, 2007. Preferred stocks are primarily issued by companies in the financial sector and were negatively affected by this year's credit crisis.

As of December 31, 2008, our investment in the high-yield municipal bond fund totaled \$33.3 million (12 percent) of the equity portfolio compared to \$34.3 million (9 percent) as of December 31, 2007. While this mutual fund is comprised of fixed income securities, as a mutual fund we treat it as an equity. In 2008, we recorded impairment losses of \$18.6 million on the high-yield municipal bond fund due to our belief that the fund is unlikely to completely recover in value in a reasonable period of time and related changes in our intent to hold this security until recovery. The holdings are comprised of lower quality investment grade and below investment grade tax-exempt securities. Sectors include healthcare, airports, tobacco, and infrastructure securities among other. The fund continues to make dividend payments and default rates of the bonds held in the fund remain below 1%. This market has been hurt by the flight to quality and overall liquidity in the municipal bond markets.

We had short-term investments and fixed income securities maturing within one year of \$126.6 million at year-end 2008. This total represented 8 percent of cash and invested assets versus 5 percent the prior year. Our short-term investments consist of money market funds.

Our investment results are summarized in the following table:

| (in thousands) | Year ended December 31, | | | | |
|--|-------------------------|--------------|--------------|--------------|--------------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Average Invested Assets (1) | \$ 1,749,303 | \$ 1,834,009 | \$ 1,763,016 | \$ 1,633,755 | \$ 1,451,539 |
| Net Investment Income (2)(3) | 78,986 | 78,901 | 71,325 | 61,641 | 54,087 |
| Net Realized Gains/(Losses) (3) | (46,738) | 28,966 | 31,045 | 16,354 | 13,365 |
| Change in Unrealized Appreciation/(Depreciation) (3)(4) | (123,607) | (14,650) | 34,395 | (35,788) | 13,200 |
| Annualized Return on Average Invested Assets | -5.2% | 5.1% | 7.8% | 2.6% | 5.6% |

(1) Average of amounts at beginning and end of each year.

(2) Investment income, net of investment expenses.

(3) Before income taxes.

(4) Relates to available-for-sale fixed income and equity securities.

Regulation

State and Federal Legislation

As an insurance holding company, we, as well as our insurance company subsidiaries, are subject to regulation by the states and territories in which the insurance subsidiaries are domiciled or transact business. Holding company registration in each insurer's state of domicile requires periodic reporting to the state regulatory authority of the financial, operational and management data of the insurers within the holding company system. All transactions within a holding company system affecting insurers must have fair and reasonable terms, and the insurer's policyholder surplus following any transaction must be both reasonable in relation to its outstanding liabilities and adequate for its needs. Notice to regulators is required prior to the consummation of certain transactions affecting insurance company subsidiaries of the holding company system.

The insurance holding company laws also require that ordinary dividends be reported to the insurer's domiciliary regulator prior to payment of the dividend and that extraordinary dividends may not be paid without such regulator's prior approval. An extraordinary dividend is generally defined under Illinois law as a dividend that, together with all other dividends made within the past 12 months, exceeds the greater of 100 percent of the insurer's statutory net income for the most recent calendar year, or 10 percent of its statutory policyholders' surplus as of the preceding year end. Insurance regulators have broad powers to prevent the reduction of statutory surplus to inadequate levels, and there is no assurance that extraordinary dividend payments would be permitted.

Other regulations impose restrictions on the amount and type of investments our insurance company subsidiaries may have. Regulations designed to ensure financial solvency of insurers and to require fair and adequate treatment and service for policyholders are enforced by filing, reporting and examination requirements. Marketplace oversight is conducted by monitoring and periodically examining trade practices, approving policy forms, licensing of agents and brokers, and requiring the filing and in some cases, approval, of premiums and commission rates to ensure they are fair and equitable. Such restrictions may limit the ability of our insurance company subsidiaries to introduce new coverages or implement desired changes to current premium rates or policy forms. Financial solvency is monitored by minimum reserve and capital requirements (including risk-based capital requirements), periodic reporting procedures (annually, quarterly, or more frequently if necessary), and periodic examinations.

The quarterly and annual financial reports to the states utilize statutory accounting principles that are different from GAAP, which show the business as a going concern. The statutory accounting principles used by regulators, in keeping with the intent to assure policyholder protection, are generally based on a solvency concept.

Many jurisdictions have laws and regulations that limit an insurer's ability to withdraw from a particular market. For example, states may limit an insurer's ability to cancel or not renew policies. Furthermore, certain states prohibit an insurer from withdrawing one or more lines of business from the state, except pursuant to a plan that is approved by the state insurance department. The state insurance department may disapprove a plan that may lead to marketplace disruption. Laws and regulations that limit cancellation and non-renewal and that subject program withdrawals to prior approval requirements may restrict our ability to exit unprofitable marketplaces in a timely manner.

In addition, state-level changes to the insurance regulatory environment are frequent, including changes caused by legislation, regulations by the state insurance regulators, and court rulings. For example, the Florida Supreme Court issued a case ruling in 2008 with the effect that surplus lines insurance in Florida is subject to the same regulation as admitted insurance in Florida, excluding rate regulation and certain other areas. Although not stated expressly in the ruling, it implies that surplus lines policy forms must be filed and approved by the Florida Office of Insurance Regulation (FOIR). In response, the FOIR has publicly stated that it disagrees with the ruling and its foundations and that the FOIR does not now nor has it ever required surplus lines insurers to comply with such form filing requirements. In early 2009, a bill was introduced in the Florida legislature to clarify the regulatory status of surplus lines insurance in Florida and provide that policy forms need not be filed and approved by the FOIR. Although the status of this situation is uncertain and at this stage we cannot predict if such legislation will become law or how this matter ultimately will be resolved, we believe it will not result in material negative consequences for us.

Virtually all states require licensed insurers to participate in various forms of guaranty associations in order to bear a portion of the loss suffered by the policyholders of insurance companies that become insolvent. Depending upon state law, licensed insurers can be assessed an amount that is generally equal to a small percentage of the annual premiums written for the relevant lines of insurance in that state to pay the claims of an insolvent insurer. These assessments may increase or decrease in the future, depending upon the rate of insolvencies of insurance companies. In some states, these assessments may be wholly or partially recovered through policy fees paid by insureds.

In addition, the insurance holding company laws require advance approval by state insurance commissioners of any change in control of an insurance company that is domiciled (or, in some cases, having such substantial business that it is deemed to be commercially domiciled) in that state. Control is generally presumed to exist through the ownership of 10 percent or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. In addition, insurance laws in many states contain provisions that require pre-notification to the insurance commissioners of a change in control of a non-domestic insurance company licensed in those states. Any future transactions that would constitute a change in control of our insurance company subsidiaries, including a change of control of us, would generally require the party acquiring control to obtain the prior approval by the insurance departments of the insurance company subsidiaries' states of domicile or commercial domicile, if any, and may require preacquisition notification in applicable states that have adopted pre-acquisition notification provisions. Obtaining these approvals could result in a material delay of, or deter, any such transaction.

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In addition to monitoring our existing regulatory obligations, we are also monitoring developments in the following areas to determine the potential effect on our business and to comply with our legal obligations.

Troubled Asset Relief Program

In 2008, in response to market and banking turmoil, the federal government implemented the Troubled Asset Relief Program (TARP), which is a federal program of the Department of Treasury designed to strengthen U.S. financial institutions through purchasing or insuring troubled assets and equity. The TARP program contains restrictions and controls on participating entities, and may be amended in the future to contain additional restrictions in areas such as executive compensation. To the extent an insurance company participates in TARP, it will be subject to all applicable restrictive and control provision. We do not currently participate in TARP and do not anticipate electing to participate in the future.

Terrorism Insurance

After the events of September 11, 2001, the National Association of Insurance Commissioners (NAIC) urged states to grant conditional approval to commercial lines endorsements that excluded coverage for acts of terrorism consistent with language developed by the Insurance Services Office, Inc. (ISO). The ISO endorsement included certain coverage limitations. Many states allowed the endorsements for commercial lines, but rejected such exclusions for personal exposures.

On November 26, 2002, the federal Terrorism Risk Insurance Act of 2002 (TRIA) became law. TRIA was extended through December 31, 2007 and reauthorized through December 31, 2014. The act, as extended and amended, provides for a federal backstop for terrorism losses as defined by the act and certified by the Secretary of the Treasury in concurrence with the Secretary of State and the U.S. Attorney General. Under TRIA, coverage provided for losses caused by acts of foreign or domestic terrorism is partially reimbursed by the United States under a formula whereby the government pays 85 percent of covered terrorism losses exceeding a prescribed deductible to the insurance company providing the coverage. The deductible is 20 percent of gross earned premium net of a few excludable lines and the federal coverage is limited to \$100 billion. Coverage under the act must be made available to policyholders, with certain specified exceptions, in commercial property and casualty policies. The immediate effect, as regards state regulation, was to nullify terrorism exclusions to the extent they exclude losses that would otherwise be covered under the act. We are in compliance with the requirements of TRIA and have made terrorism coverage available to applicable policyholders. Given the challenges associated with attempting to assess the possibility of future acts of terror exposures and assign an appropriate price to the risk, we have taken a conservative underwriting position on most of our affected coverages.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 presents a significant expansion of securities law regulation of corporate governance and compliance, accounting practices, reporting, and disclosure that affects publicly traded companies. The act, in part, sets forth requirements for certification by CEOs and CFOs of certain reports filed with the Securities and Exchange Commission (SEC), disclosures pertaining to the adoption of a code of ethics applicable to certain management personnel, and safeguards against actions to fraudulently influence, manipulate or mislead independent public or certified accountants of the issuer's financial statements. It also provides stronger requirements for development and evaluation of internal control procedures, as well as provisions pertaining to a company's audit committee of the board of directors. As required by the act and under the supervision from and participation of management, we annually complete an evaluation of our internal control system including all design, assessment, documentation, and testing phases. This evaluation is intended to identify any deficiencies, measure their materiality, and implement procedures, where necessary, to remediate them.

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The annual certification of our CEO with respect to compliance with the New York Stock Exchange (NYSE) corporate governance listing standards has been submitted to the NYSE and the annual certifications of our CEO and CFO required by the Sarbanes-Oxley Act of 2002 with respect to our 2008 fiscal year have been filed with the SEC as an exhibit to our annual report on Form 10-K for 2008.

Federal Regulation of Insurance

The U.S. insurance industry is not currently subject to any significant amount of federal regulation, and instead is regulated principally at the state level. However, federal insurance legislation of various types is periodically

proposed in Congress, and in 2007 several bills were introduced in Congress that would impact and regulate various aspects of the insurance industry. These proposed laws covered many areas, including amending and extending the current TRIA law, optional federal charter, streamlining state regulation of nonadmitted insurance, expanding the national flood insurance program, creating a national catastrophe insurance program, and ending the antitrust exemption for insurance companies. However, only the extension and amendment of the TRIA law was enacted. In 2008, such proposals were limited, but we expect that the federal government's reaction to the economic and financial market turmoil will include some type of federal oversight of the insurance industry, including possibly establishing a federal insurance charter and a federal Office of Insurance Information. We cannot predict whether one or more of the other proposed bills will again be proposed or enacted or whether any significant federal involvement in insurance regulation will be implemented in 2009 or later, or the impact of any such laws or regulation on our company. We will continue to monitor all significant federal insurance legislation.

Corporate Compliance

We have a code of conduct, corporate governance guidelines, and compliance manual, which provide directors, officers, and employees with guidance and requirements for complying with a variety of federal and state laws and company policies. Electronic versions of these documents, as well as the following documents, are, or will be, available on our web site (www.rlicorp.com): 2008 summary annual report; 2008 financial report; 2009 proxy statement; annual report on Form 10-K for 2008; and charters of the executive resources, audit, finance and investment, strategy, and nominating/corporate governance committees of our board of directors. Printed copies of these documents will be made available upon request without charge to any shareholder.

Licenses and Trademarks

We enter into various license arrangements with third parties and vendors on a regular basis for various goods and services. We have a software license and services agreement with Risk Management Solutions, Inc. for the modeling of natural hazard catastrophes. The license is renewed on an annual basis. RLI Insurance Company has a perpetual license with AIG Technology Enterprises, Inc. for policy management, claims processing, premium accounting, file maintenance, financial/management reporting, reinsurance processing, and statistical reporting. We also enter into other software licensing agreements in the ordinary course of business.

We obtained U.S. federal service mark registration of our corporate logo "RLI" and several other company service mark and trade names with the U.S. Patent and Trademark Office. Such registrations protect the marks nationwide from deceptively similar use. The duration of these registrations is 10 years unless renewed. We monitor our trademarks and service marks and protect them from unauthorized use as necessary.

Employees

As of December 31, 2008, we employed a total of 783 associates. Of the 783 total associates, 65 were part-time and 718 were full-time.

Forward Looking Statements

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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 appear throughout this report. These statements relate to our current expectations, beliefs, intentions, goals or strategies regarding the future and are based on certain underlying assumptions by us. These forward looking statements generally include words such as expect, will, should, anticipate, believe, and similar expressions. Such assumptions are, in turn, based on information available and internal estimates and analyses of general economic conditions, competitive factors, conditions specific to the property and casualty insurance industry, claims development, and the impact thereof on our loss reserves, the adequacy of our reinsurance programs, developments in the securities market and the impact on our investment portfolio, regulatory changes and conditions, and other factors and are subject to various risks, uncertainties, and other factors, including, without limitation those set forth below in Item 1A Risk Factors. Actual results could differ materially from those expressed in, or implied by, these forward looking statements. We assume no obligation to update any such statements. You should review the various risks, uncertainties, and other factors listed from time to time in our Securities and Exchange Commission filings.

Item 1A. Risk Factors

Our results of operations and revenues may fluctuate as a result of many factors, including cyclical changes in the insurance industry, which may cause the price of our securities to be volatile.

The results of operations of companies in the property and casualty insurance industry historically have been subject to significant fluctuations and uncertainties. Our profitability can be affected significantly by:

- competitive pressures impacting our ability to retain business at an adequate rate;
- rising levels of loss costs that we cannot anticipate at the time we price our coverages;
- volatile and unpredictable developments, including man-made, weather-related and other natural catastrophes or terrorist attacks;
- changes in the level of reinsurance capacity;
- changes in the amount of loss reserves resulting from new types of claims and new or changing judicial interpretations relating to the scope of insurers' liabilities;
- fluctuations in equity markets and interest rates, inflationary pressures and other changes in the investment environment, which affect returns on invested assets and may impact the ultimate payout of losses; and
- adverse conditions in the financial services industry which can make access to capital more difficult.

In addition, the demand for property and casualty insurance can vary significantly, rising as the overall level of economic activity increases and falling as that activity decreases, causing our revenues to fluctuate. These fluctuations in results of operations and revenues may cause the price of our securities to be volatile.

Catastrophic losses, including those caused by natural disasters, such as earthquakes and hurricanes, or man-made events such as terrorist attacks, are inherently unpredictable and could cause us to suffer material financial losses.

One of the largest risks of loss we face in the ordinary course of our business is property damage resulting from catastrophic events, particularly earthquakes on the West Coast and hurricanes and tropical storms affecting the continental U.S. or Hawaii. Most of our past catastrophe-related claims have resulted from earthquakes and hurricanes. For example, we incurred a pre-tax net loss of \$64.3 million related to the 1994 Northridge earthquake. In recent years, hurricanes have had a significant impact on our results. In 2008, we incurred a pre-tax loss of \$24.0 million on hurricanes Ike and Gustav. We incurred a pre-tax loss of \$22.5 million from the 2005 hurricanes, Katrina, Rita, and Wilma. Catastrophes can also be caused by various events, including windstorms, hailstorms, explosions, severe winter weather, and fires and may include terrorist events such as the attacks on the World Trade Center and the Pentagon on September 11, 2001.

The incidence and severity of catastrophes are inherently unpredictable. 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. Most catastrophes are restricted to fairly specific geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. Catastrophes can cause losses in a variety of our property and casualty segments, and it is possible that a catastrophic event or multiple catastrophic events could cause us to suffer material financial losses.

Actual insured losses may be greater than our loss reserves, which would negatively impact our profitability.

Significant periods of time often elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities representing estimates of amounts needed to pay reported and unreported losses and the related loss adjustment expenses. Loss reserves are just an estimate of what we anticipate the ultimate costs of claims to be and do not represent an exact calculation of liability. Estimating loss reserves is a difficult and complex process involving many variables and subjective judgments. As part of the reserving process, we review historical data and consider the impact of various factors such as:

- loss emergence patterns;
- underlying policy terms and conditions;
- business and exposure mix;
- trends in claim frequency and severity;
- changes in operations;
- emerging economic and social trends;

- inflation; and
- changes in the regulatory and litigation environments.

This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. It also assumes that adequate historical or other data exists upon which to make these judgments. There is no precise method, however, for evaluating the impact of any specific factor on the adequacy of reserves, and actual results are likely to differ from original estimates. If the actual amount of insured losses is greater than the amount we have reserved for these losses, our profitability could suffer.

We may suffer losses from litigation, which could materially and adversely affect our financial condition and business operations.

As is typical in our industry, we face risks associated with litigation. For example, we are currently involved in a complex litigation arising out of an equipment and vehicle leasing program of Commercial Money Center (CMC). We have reached settlements with all five investor banks that made claims under the lease bonds issued by RLI and expect the remaining CMC-related litigation involving us to be concluded in 2009. We were also a defendant in complex private litigation brought against insurance brokers and insurance companies alleging injury from the payment of contingent commissions by insurers to brokers. We were released from the suit without payment of any settlement fees in 2007 but paid significant legal expenses in defending ourselves. Litigation is subject to inherent uncertainties, and if there were an outcome unfavorable to us in another matter, there exists the possibility of a material adverse impact on our results of operations in the period in which the outcome occurs. Please refer to Item 3, Legal Proceedings.

Our reinsurers may not pay on losses in a timely fashion, or at all, which may increase our costs.

We purchase reinsurance by transferring part of the risk we have assumed (known as ceding) to a reinsurance company in exchange for part of the premium we receive in connection with the risk. 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 liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. That is, our reinsurers may not pay claims made by us on a timely basis, or they may not pay some or all of these claims, for a variety of reasons. Either of these events would increase our costs and could have a materially adverse effect on our business.

If we cannot obtain adequate reinsurance protection for the risks we have underwritten, we may be exposed to greater losses from these risks or we may reduce the amount of business we underwrite, which will reduce our revenues.

Market conditions beyond our control determine the availability and cost of the reinsurance protection that 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 be sure that we can maintain our current reinsurance facilities or that we can obtain other reinsurance facilities in adequate amounts and at favorable rates. If we are unable to renew our expiring facilities or to obtain new reinsurance facilities on terms we deem acceptable, either our net exposures would increase - which could increase our costs - or, if we were unwilling to bear an increase in net exposures, we would have to reduce the level of our underwriting commitments - especially catastrophe exposed risks - which would reduce our revenues.

Our investment results and, therefore, our financial condition may be impacted by changes in the business, financial condition or operating results of the entities in which we invest, as well as changes in interest rates, government monetary policies, general economic conditions, liquidity and overall market conditions.

We invest the premiums we receive from customers until they are needed to pay policyholder claims or until they are recognized as profits. At December 31, 2008, our investment portfolio consisted of \$1.3 billion in fixed income securities, \$286.8 million in equity securities and \$98.0 million in short-term investments. For the 12 months ended December 31, 2008, we experienced a \$124.0 million pre-tax unrealized loss on our investment portfolio. For the fiscal year ended December 31, 2007, we experienced \$14.7 million in pre-tax unrealized losses on our investment portfolio. The 2008 and 2007 losses primarily reflect the unprecedented levels of volatility and disruptions in the overall stock and bond markets. Fluctuations in the value of our investment portfolio can occur as a result of changes in the business, financial condition or operating results of the entities in which we invest, as well as changes in interest rates, government monetary policies, liquidity of holdings and general economic conditions. These fluctuations may, in turn, negatively impact our financial condition and impair our ability to raise capital, if needed.

We compete with a large number of companies in the insurance industry for underwriting revenues.

We compete with a large number of other companies in our selected lines of business. We face competition both from specialty insurance companies, underwriting agencies and intermediaries, as well as diversified financial services companies that are significantly larger than we are and that have significantly greater financial, marketing, management and other resources than we do. Some of these competitors also have significantly greater experience and market recognition than we do. We may incur increased costs in competing for underwriting revenues. If we are unable to compete effectively in the markets in which we operate or to expand our operations into new markets, our underwriting revenues may decline, as well as overall business results.

A number of new, proposed or potential legislative or industry developments could further increase competition in our industry. These developments include:

- an increase in capital-raising by companies in our lines of business, which could result in new entrants to our markets and an excess of capital in the industry;
- the deregulation of commercial insurance lines in certain states and the possibility of federal regulatory reform of the insurance industry, which could increase competition from standard carriers for our excess and surplus lines of insurance business;
- programs in which state-sponsored entities provide property insurance in catastrophe-prone areas or other alternative markets types of coverage; and
- changing practices caused by the Internet, which may lead to greater competition in the insurance business.

New competition from these developments could cause the supply and/or demand for insurance or reinsurance to change, which could affect our ability to price our coverages at attractive rates and thereby adversely affect our underwriting results.

A downgrade in our ratings from A.M. Best, Standard & Poor's, or Moody's could negatively affect our business.

Ratings are a critical factor in establishing the competitive position of insurance companies. Our insurance companies are rated by A.M. Best, Standard & Poor's, and Moody's. A.M. Best, Standard & Poor's and Moody's ratings reflect their opinions of an insurance company's and an 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 such firms, and we cannot assure the continued maintenance of our current ratings. All of our ratings were reviewed during 2008. A.M. Best reaffirmed its A+, Superior rating for the combined entity of RLI Insurance Company, Mt. Hawley Insurance Company, and RLI Indemnity Company (RLI Group). Standard and Poor's reaffirmed our A+, Strong rating for the group. Moody's reaffirmed our group rating of A2, Good for RLI Group. Because these ratings have become an increasingly important factor in establishing the competitive position of insurance companies, if our ratings are reduced from their current levels by any of A.M. Best, Standard & Poor's or Moody's, our competitive position in the industry, and therefore our business, could be adversely affected. A significant downgrade could result in a substantial loss of business as policyholders might move to other companies with higher claims-paying and financial strength ratings.

We are subject to extensive governmental regulation, which may adversely affect our ability to achieve our business objectives. Moreover, if we fail to comply with these regulations, we may be subject to penalties, including fines and suspensions, which may adversely affect our financial condition and results of operations.

We are subject to extensive governmental regulation and supervision. Most insurance regulations are designed to protect the interests of policyholders rather than shareholders and other investors. These regulations, generally administered by a department of insurance in each state in which we do business, relate to, among other things:

- approval of policy forms and premium rates;
- standards of solvency, including risk-based capital measurements;
- licensing of insurers and their producers;
- restrictions on the nature, quality and concentration of investments;
- restrictions on the ability of our insurance company subsidiaries to pay dividends to us;
- restrictions on transactions between insurance company subsidiaries and their affiliates;
- restrictions on the size of risks insurable under a single policy;
- requiring deposits for the benefit of policyholders;
- requiring certain methods of accounting;
- periodic examinations of our operations and finances;

- prescribing the form and content of records of financial condition required to be filed; and
- requiring reserves for unearned premium, losses and other purposes.

State insurance departments also conduct periodic examinations of the affairs of insurance companies and require the filing of annual and other reports relating to financial condition, holding company issues and other matters. These regulatory requirements may adversely affect or inhibit our ability to achieve some or all of our business objectives.

In addition, regulatory authorities have relatively broad discretion to 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 practices that we believe may be generally followed by the industry. These practices may turn out to be different from the interpretations of regulatory authorities. If we do not have the requisite licenses and approvals or do not comply with applicable regulatory requirements, insurance regulatory authorities could preclude or temporarily suspend us from carrying on some or all of our activities or otherwise penalize us. This could adversely affect our ability to operate our business. Further, changes in the level of regulation of the insurance industry or changes in laws or regulations themselves or interpretations by regulatory authorities could adversely affect our ability to operate our business.

In addition to regulations specific to the insurance industry, including principally the insurance laws of Illinois, where we are based, as a public company we are also subject to regulation by the U. S. Securities and Exchange Commission and the New York Stock Exchange, each of which regulate many areas such as financial and business disclosures, corporate governance, and shareholder matters. We are also subject to the corporation laws of Illinois, where we and each of our four insurance company subsidiaries are incorporated. We monitor these laws, regulations and rules on an ongoing basis, and make appropriate changes as necessary. Implementing such changes may require adjustments to our business methods, increase our costs and other changes that could cause us to be less competitive in our industry.

We may be unable to attract and retain qualified key employees.

We depend on our ability to attract and retain qualified executive officers, experienced underwriting talent and other skilled employees who are knowledgeable about our business. If we cannot attract or retain top-performing executive officers, underwriters, and other personnel, or if the quality of their performance 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.

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

RLI Corp. is the holding company for our three principal insurance operating companies. At the holding company level, our principal assets are the shares of capital stock of our insurance company subsidiaries. We may rely on dividends from our insurance company subsidiaries to meet our obligations for paying principal and interest on outstanding debt obligations, dividends to shareholders and corporate expenses. The payment of dividends by our insurance company subsidiaries will depend on the surplus and future earnings of these subsidiaries and is also subject to regulatory restrictions. The maximum dividend distribution in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Insurance Company's policyholder surplus as of December 31 of the preceding year or their net income for the 12-month period ending December 31 of the preceding year. These levels may be exceeded in some cases with prior approval from the Illinois Department of Insurance. The maximum dividend distribution that can be paid by RLI Insurance Company during 2009 without prior insurance department approval is

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\$67.8 million, or 10 percent of RLI Insurance Company's 2008 policyholder surplus. As a result, we may not be able to receive dividends from our subsidiaries at times and in amounts necessary to meet our debt service obligations or to pay dividends to our shareholders or corporate expenses. During 2008, RLI Insurance Company paid total dividends of \$70.0 million to RLI Corp.

Anti-takeover provisions affecting us could prevent or delay a change of control that is beneficial to you.

Provisions of our articles of incorporation and by-laws, and provisions of applicable Illinois law and applicable federal and state regulations may discourage, delay or prevent a merger, tender offer or other change of control that holders of our securities may consider favorable. Certain of these provisions impose various procedural and other

requirements that could make it more difficult for shareholders to effect certain corporate actions. These provisions could:

- have the effect of delaying, deferring or preventing a change in control of us;
- discourage bids for our securities at a premium over the market price;
- adversely affect the market price of, and the voting and other rights of the holders of, our securities; or
- impede the ability of the holders of our securities to change our management.

Breaches or interruptions of our computer systems could adversely affect our financial condition and results of operations.

We rely on multiple computer systems to issue policies, pay claims, run modeling functions, and complete various internal processes. These systems may be exposed to unplanned interruption, unreliability, and data breaches.

Any such issues could materially impact our company, including the impairment of information availability, compromise of system integrity/accuracy, reduction of our volume of transactions, and interruption of our general business. Although we believe we currently have adequate safeguards in place, we cannot guarantee that such problems will never occur. If they do, interruption to our business and related costs could be significant, which could impair our profitability.

We may not be able to effectively start up or integrate a new product opportunity.

Our ability to grow our business depends in part on our creation, implementation and acquisition of new insurance products that are profitable and fit within our business model. New product launches are subject to many obstacles, including ensuring we have sufficient business and systems processes, determining appropriate pricing, assessing opportunity costs and regulatory burdens, and planning for internal infrastructure needs. If we cannot accurately assess and overcome these obstacles or we improperly implement new insurance products, our ability to grow organically and profitably will be impaired.

Access to capital and market liquidity has generally been more difficult and may adversely affect our ability to take advantage of business opportunities as they arise.

Our ability to grow our business depends in part on our ability to access capital when needed. Because of adverse conditions in the financial services industry, access to capital has generally become more difficult. In addition, we cannot predict the extent and duration of current economic and market disruptions, the impact of government interventions (including, among other things, TARP, the current economic stimulus package, etc.) into the market to address these disruptions, and their combined impact on our industry, business and investment portfolios.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

We own six commercial buildings in Peoria, Illinois. Our primary building is a two-story 80,000 square foot office building, which serves as our corporate headquarters. Located on the same 20.6 acre campus is a 24,000 square foot building which is used by two branch offices of RLI Insurance Company and a supporting department. We also own a 25,400 square foot multi-story building used for record storage, a training center and office space. Our corporate campus also includes a 12,800 square foot building used as storage for furniture and equipment and for office space. The final structure is a 15,000 square foot office building, of which 10,000 square feet is leased. We share ownership with Maui Jim, Inc. of a 16,800 square foot airplane hangar located at the Greater Peoria Regional Airport.

Most of our branch offices and other company operations lease office space throughout the country.

Item 3. Legal Proceedings

We are the plaintiff and a defendant in an action captioned RLI Insurance Co. v. Commercial Money Center (CMC), which was filed in U.S. District Court, Southern District of California (San Diego) on February 1, 2002.

Other defendants in that action are Commercial Servicing Corporation (CSC), Sterling Wayne Pirtle, Anita Pirtle, Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank and Sky Bank. We filed a similar complaint against the Bank of Waukegan in San Diego, California Superior Court. Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, Sky Bank and Bank of Waukegan are referred to here as the investor banks. The litigation arises out of the equipment and vehicle leasing program of CMC. CMC originated leases, procured bonds pertaining to the performance of obligations of each lessee under each lease, and then formed pools of such leases that it marketed to banks and other institutional investors. We sued for rescission and/or exoneration of the bonds we issued to CMC and sale and servicing agreements we entered into with CMC and the investor banks, which had invested in CMC's equipment leasing program. We contend we were fraudulently induced to issue the bonds and enter into the agreements by CMC, who misrepresented and concealed the true nature of its program and the underlying leases originated by CMC (for which bonds were procured). We also sued for declaratory relief to determine our rights and obligations, if any, under the instruments. Each investor bank disputes our claims for relief. CMC is currently in Chapter 7 bankruptcy proceedings.

Between the dates of April 4 and April 18, 2002, each investor bank subsequently filed a complaint against us in various state courts, which we removed to U.S. District Courts. Each investor bank sued us on certain bonds we issued to CMC as well as a sale and servicing agreement between the investor bank, CMC and us. Each investor bank sued for breach of contract, bad faith and other extra-contractual theories. We have answered and denied each investor bank's claim to entitlement to relief. The investor banks claimed entitlement to aggregate payment of approximately \$53 million under either the surety bonds or the sale and servicing agreements, plus unknown extra-contractual damages, attorney's fees and interest. On October 25, 2002, the judicial panel for multi-district litigation (MDL Panel) transferred 23 actions pending in five federal districts involving numerous investor banks, five insurance companies and CMC to the Federal District Court for the Northern District of Ohio for consolidated pre-trial proceedings, assigning the litigation to the Honorable Kathleen O. Malley.

In the third quarter of 2005, we reached a confidential settlement agreement with Lakeland Bank. This settlement ended our litigation with Lakeland, but did not resolve our pending litigation with the four other investor banks. The settlement with Lakeland related to surety bonds representing approximately 17 percent of the amount to which the five investor banks had claimed entitlement. The settlement did not have a material adverse effect on our financial statements taken as a whole. In addition, in August 2005, the Federal District Court denied outright the investor banks' motion for judgment on the pleadings and subsequently ordered all remaining cases to mandatory mediation. Mediations held in January 2006 between us and each of the four remaining investor banks did not resolve the claims of those investor banks. In September 2006, the Court issued a case management order governing expert witness discovery and future motion practice. In the second quarter of 2007, we reached a confidential settlement agreement with Sky Bank. In the third quarter of 2007, we reached a confidential settlement agreement with Americana Bank. These settlements ended our litigation with Sky Bank and Americana Bank but did not resolve our pending litigation with the remaining two investor banks (Bank of Waukegan and Atlantic Coast Federal, whose initial bond penal sum claims total approximately \$9.3 million). The settlements with Sky Bank and Americana Bank related to surety bonds representing approximately 66 percent of the amount to which the five investor banks had claimed entitlement. In the first quarter of 2008, we reached a confidential settlement agreement with the Bank of Waukegan. In the fourth quarter of 2008, we reached a confidential settlement agreement with Atlantic Coast Federal Bank. The settlements with Bank of Waukegan and Atlantic Coast Federal related to surety bonds representing approximately 17 percent of the amount to which the five investor banks had claimed entitlement. With these latter two settlements, we have now reached settlements with each of the five investor banks that had claimed entitlement under the surety bonds issued by RLI.

In addition, we are party to numerous claims and losses that arise in the normal course of our business. Many of such claims or losses involve claims under policies that we underwrite as an insurer. We believe that the resolution of these claims and losses will not have a material adverse effect on our financial condition, results of operations or cash flows. We are also involved in various other legal proceedings and litigation unrelated to our insurance business that arise in the ordinary course of business operations. Management believes that any liabilities that may arise as a result of these legal matters will not have a material adverse effect on our financial condition or operating results.

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

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No matters were submitted by the Company to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

PART II

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

(a) Refer to the Corporate Data on page 64 of the 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein for information on the market on which our common stock is traded, holders of our common stock and dividends.

Refer to Part III, Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters, of this document for information on securities authorized for issuance under our equity compensation plan.

(b) Not applicable.

(c) Our common stock repurchase program, which authorized us to repurchase up to \$100 million of our Company's common stock, was initially approved by our Board of Directors on May 3, 2007. On November 14, 2007, our Board of Directors increased the previously announced repurchase program by \$100 million, for a total of \$200 million of our common stock. The repurchase program may be suspended or discontinued at any time without prior notice. In light of market volatility in the second half of 2008, the repurchase program was suspended in the third quarter of 2008 and will remain suspended until conditions warrant its reactivation.

Item 6. Selected Financial Data

Refer to the Selected Financial Data on pages 62 through 63 of the 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

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

Refer to the Management's Discussion and Analysis of Financial Condition and Results of Operations on pages 1 through 27 of the 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein. Certain accounting policies are viewed by Management to be critical accounting policies. These policies relate to unpaid loss and settlement expenses, investment valuation, recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes. A detailed discussion of these critical accounting policies can be found on pages 3 through 8 of the 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

Throughout this report (including portions incorporated by reference herein), we present our operations in the way we believe will be most meaningful, useful and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP presentation of net income and certain statutory reporting information, we show certain non-GAAP financial measures that are valuable in

managing our business, including underwriting income, gross premiums written, net written premiums and combined ratios. A detailed discussion of these measures can be found on page 2 of the 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Refer to the Management's Discussion and Analysis of Financial Condition and Results of Operations on pages 1 through 27 of the 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

Item 8. Financial Statements and Supplementary Data

Refer to the consolidated financial statements and supplementary data included on pages 28 through 61 of the 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein. (See also Index to Financial Statements and Schedules on page 46.)

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

There were no changes in accountants or disagreements with accountants on any matters of accounting principles or practices or financial statement disclosure.

Item 9A. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of December 31, 2008.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control - Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2008.

Our internal control over financial reporting as of December 31, 2008 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report on page 58 of the 2008 Financial Report to Shareholders, attached as Exhibit 13.

There was no change in our internal control over financial reporting during our fourth fiscal quarter ended December 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None

PART III

Items 10 to 14.

Pursuant to General Instructions G(3) of Form 10-K, Items 10 to 14, inclusive, have not been restated or answered because the Company intends to file within 120 days after the close of its fiscal year with the Securities and Exchange Commission a definitive proxy statement pursuant to Regulation 14A under the Securities Exchange Act of 1934, which proxy statement involves the election of directors. The information required in these items 10 to 14, inclusive, is incorporated by reference to that proxy statement.

PART IV

Item 15. Exhibits and Financial Statement Schedules

- (a) (1-2) Consolidated Financial Statements and Schedules. See Index to Financial Statements and Schedules attached.
- (3) Exhibits. See Exhibit Index on pages 57-58.
- (b) Exhibits. See Exhibit Index on pages 57-58.
- (c) Financial Statement Schedules. The schedules included on attached pages 48 through 56 as required by Regulation S-X are excluded from the Company's 2008 Financial Report to Shareholders. See Index to Financial Statements and Schedules on page 46. There is no other financial information required by Regulation S-X that is excluded from the Company's 2008 Financial Report to Shareholders.

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.

RLI Corp.

(Registrant)

By: /s/Joseph E. Dondanville
Joseph E. Dondanville
Senior Vice President, Chief Financial Officer

Date: February 25, 2009

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

By: /s/Jonathan E. Michael
Jonathan E. Michael, President, CEO
(Principal Executive Officer)

Date: February 25, 2009

By: /s/Joseph E. Dondanville
Joseph E. Dondanville, Senior Vice President
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

Date: February 25, 2009

By: /s/Gerald D. Stephens
Gerald D. Stephens, Director

Date: February 25, 2009

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By: /s/Kaj Ahlmann
Kaj Ahlmann, Director

Date: February 25, 2009

By: /s/Barbara R. Allen
Barbara R. Allen, Director

Date: February 25, 2009

By: /s/John T. Baily
John T. Baily, Director

Date: February 25, 2009

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By: /s/Richard H. Blum
Richard H. Blum, Director

Date: February 25, 2009

By: /s/Jordan W. Graham
Jordan W. Graham, Director

Date: February 25, 2009

By: /s/Gerald I. Lenrow
Gerald I. Lenrow, Director

Date: February 25, 2009

By: /s/Charles M. Linke
Charles M. Linke, Director

Date: February 25, 2009

By: /s/F. Lynn McPheeters
F. Lynn McPheeters, Director

Date: February 25, 2009

By: /s/Jonathan E. Michael
Jonathan E. Michael, Director

Date: February 25, 2009

By: /s/Edward F. Sutkowski
Edward F. Sutkowski, Director

Date: February 25, 2009

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By: /s/Robert O. Viets
Robert O. Viets, Director

Date: February 25, 2009

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Schedules other than those listed are omitted for the reason that they are not required, are not applicable or that equivalent information has been included in the financial statements, and notes thereto, or elsewhere herein.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
RLI Corp.:

Under date of February 25, 2009, we reported on the consolidated balance sheets of RLI Corp. and Subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of earnings and comprehensive earnings, cash flows, and shareholders equity for each of the years in the three-year period ended December 31, 2008, as contained in the 2008 Financial Report to Shareholders. These consolidated financial statements and our report thereon are incorporated by reference in the annual report on Form 10-K for the year ended December 31, 2008. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related financial statement schedules included in the annual report on Form 10-K for the year ended December 31, 2008. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits.

In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Chicago, Illinois
February 25, 2009

RLI CORP. AND SUBSIDIARIES

SCHEDULE I SUMMARY OF INVESTMENTS OTHER THAN INVESTMENTS

IN RELATED PARTIES

December 31, 2008

| Column A (in thousands) | Column B | Column C | Column D |
|--|--------------|--------------|--|
| Type of Investment | Cost (1) | Fair Value | Amount at which shown in the balance sheet |
| Fixed maturities: | | | |
| Bonds: | | | |
| Available-for-sale | | | |
| U.S. Government | \$ 6,596 | \$ 7,065 | \$ 7,065 |
| U.S. Agencies | 285,937 | 288,177 | 288,177 |
| Mtge/ABS/CMO* | 233,275 | 231,522 | 231,522 |
| Corporate | 287,557 | 270,164 | 270,164 |
| States, political subdivisions, and revenues | 423,311 | 427,287 | 427,287 |
| Total available-for-sale | \$ 1,236,676 | \$ 1,224,215 | \$ 1,224,215 |
| Held-to-maturity | | | |
| U.S. Government | \$ 4,916 | \$ 5,019 | \$ 4,916 |
| U.S. Agencies | 8,960 | 9,916 | 8,960 |
| State, political subdivisions, and revenues | 25,945 | 26,486 | 25,945 |
| Total held-to-maturity | \$ 39,821 | \$ 41,421 | \$ 39,821 |
| Trading | | | |
| U.S. Government | \$ 1,150 | \$ 1,312 | \$ 1,312 |
| U.S. Agencies | 0 | 0 | 0 |
| Mtge/ABS/CMO* | 6,097 | 5,881 | 5,881 |
| Corporate | 2,935 | 2,722 | 2,722 |
| States, political subdivisions, and revenues | 100 | 105 | 105 |
| Total trading | \$ 10,282 | \$ 10,020 | \$ 10,020 |
| Total fixed maturities | \$ 1,286,779 | \$ 1,275,656 | \$ 1,274,056 |
| Equity securities, available-for-sale | | | |
| Common stock | | | |
| Public utilities | \$ 30,566 | \$ 43,093 | \$ 43,093 |
| Banks, trusts and insurance companies | 11,071 | 14,792 | 14,792 |
| Industrial, miscellaneous and all other | 198,185 | 217,024 | 217,024 |
| Total common stock | \$ 239,822 | \$ 274,909 | \$ 274,909 |
| Preferred Stock | | | |
| Perpetual Preferred Stock | \$ 4,932 | \$ 4,815 | \$ 4,815 |
| Redeemable Preferred Stock | 6,529 | 7,066 | 7,066 |
| Total preferred stock | \$ 11,461 | \$ 11,881 | \$ 11,881 |
| Total equity securities | \$ 251,283 | \$ 286,790 | \$ 286,790 |

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| | | | | | | |
|------------------------|----|-----------|----|-----------|----|-----------|
| Short-term investments | \$ | 97,982 | \$ | 97,982 | \$ | 97,982 |
| Total investments | \$ | 1,636,044 | \$ | 1,660,428 | \$ | 1,658,828 |

*Mortgage-backed, asset-backed & collateralized mortgage obligations.

(1) Original cost of equity securities and, as to fixed maturities, original cost reduced by repayments and adjusted for amortization of premiums or accrual of discounts.

Note: See notes 1E and 2 of Notes to Consolidated Financial Statements, as attached in Exhibit 13. See also the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(PARENT COMPANY)

CONDENSED BALANCE SHEETS

December 31,

| (in thousands, except share data) | 2008 | 2007 |
|--|------------|------------|
| ASSETS | | |
| Cash | \$ 375 | \$ 1 |
| Short-term investments, at cost which approximates fair value | 2,667 | 466 |
| Investments in subsidiaries/investees, at equity value | 795,211 | 863,744 |
| Fixed income: | | |
| Available-for-sale, at fair value (amortized cost - \$28,735 in 2008 and \$30,013 in 2007) | 28,925 | 30,293 |
| Property and equipment, at cost, net of accumulated depreciation of \$1,839 in 2008 and \$1,570 in 2007 | 5,531 | 5,772 |
| Deferred debt costs | 540 | 647 |
| Other assets | 777 | 996 |
| Total assets | \$ 834,026 | \$ 901,919 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Liabilities: | | |
| Accounts payable, affiliates | \$ 2,964 | \$ 7,235 |
| Dividends payable | 6,109 | 5,561 |
| Income taxes payable - current | 1,244 | 82 |
| Income taxes payable - deferred | 12,204 | 11,255 |
| Bonds payable, long-term debt | 100,000 | 100,000 |
| Interest payable, long-term debt | 2,727 | 2,727 |
| Other liabilities | 624 | 637 |
| Total liabilities | \$ 125,872 | \$ 127,497 |
| Shareholders' equity: | | |
| Common stock (\$1 par value, authorized 50,000,000 shares, issued 32,106,085 shares in 2008 and 31,869,596 shares in 2007) | \$ 32,106 | \$ 31,870 |
| Paid in capital | 196,989 | 192,446 |
| Accumulated other comprehensive earnings, net of tax | 15,130 | 95,701 |
| Retained earnings | 807,195 | 749,767 |
| Deferred compensation | 8,312 | 7,980 |
| Treasury shares at cost (10,631,656 shares in 2008 and 9,714,456 shares in 2007) | (351,578) | (303,342) |
| Total shareholders' equity | \$ 708,154 | \$ 774,422 |
| Total liabilities and shareholders' equity | \$ 834,026 | \$ 901,919 |

See Notes to Consolidated Financial Statements, as attached in Exhibit 13. See also the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(PARENT COMPANY) (continued)

CONDENSED STATEMENTS OF EARNINGS AND COMPREHENSIVE EARNINGS

Years ended December 31,

| (in thousands) | 2008 | 2007 | 2006 |
|---|------------|------------|------------|
| Net investment income | \$ 1,739 | \$ 1,649 | \$ 913 |
| Net realized investment gains | 72 | 364 | 24,417 |
| Equity in earnings of unconsolidated investees | 4,844 | 7,315 | 13,702 |
| Selling, general and administrative expenses | (6,853) | (9,474) | (8,070) |
| Interest expense on debt | (6,046) | (6,040) | (6,040) |
| Earnings (loss) before income taxes | (6,244) | (6,186) | 24,922 |
| Income tax expense (benefit) | (5,750) | (2,665) | 7,477 |
| Net earnings (loss) before equity in net earnings of subsidiaries | (494) | (3,521) | 17,445 |
| Equity in net earnings of subsidiaries | 79,170 | 179,388 | 117,194 |
| Net earnings | \$ 78,676 | \$ 175,867 | \$ 134,639 |
| Other comprehensive earnings (loss), net of tax | | | |
| Unrealized gains on securities: | | | |
| Unrealized holding gains (losses) arising during the period | \$ (33) | \$ 322 | \$ 837 |
| Less: reclassification adjustment for gains included in net earnings | (25) | (140) | (2,896) |
| Other comprehensive earnings (loss)-parent only | (58) | 182 | (2,059) |
| Equity in other comprehensive earnings (loss) of subsidiaries/investees | (80,513) | (9,626) | 24,419 |
| Other comprehensive earnings (loss) | (80,571) | (9,444) | 22,360 |
| Comprehensive earnings (loss) | \$ (1,895) | \$ 166,423 | \$ 156,999 |

See Notes to Consolidated Financial Statements, as attached in Exhibit 13. See also the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE II CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(PARENT COMPANY) (continued)

CONDENSED STATEMENTS OF CASH FLOWS

Years ended December 31,

| (in thousands) | 2008 | 2007 | 2006 |
|---|----------|------------|-----------|
| Cash flows from operating activities | | | |
| Earnings (loss) before equity in net earnings of subsidiaries | \$ (494) | \$ (3,521) | \$ 17,445 |
| Adjustments to reconcile net losses to net cash provided by (used in) operating activities: | | | |
| Net realized investment gains | (72) | (364) | (24,417) |
| Depreciation | 269 | 267 | 261 |
| Other items, net | 2,823 | 1,258 | (695) |
| Change in: | | | |
| Affiliate balances payable | (4,271) | 5,565 | (822) |
| Federal income taxes | 7,193 | (4,794) | 6,656 |
| Stock option excess tax benefit | (4,929) | (2,042) | (2,930) |
| Changes in investment in unconsolidated investees: | | | |
| Undistributed earnings | (4,844) | (7,315) | (13,702) |
| Dividends received | 3,960 | 5,940 | 16,500 |
| Net cash provided by (used in) operating activities | (365) | (5,006) | (1,704) |
| Cash flows from investing activities | | | |
| Purchase of: | | | |
| Fixed income, available-for-sale | (30,932) | (47,376) | 0 |
| Equity securities, available-for-sale | 0 | 0 | (64,180) |
| Short-term investments, net | (4,700) | 0 | (33,502) |
| Property and equipment | (28) | (15) | (20) |
| Sale of: | | | |
| Fixed income, available-for-sale | 0 | 7,410 | 0 |
| Equity securities, available-for-sale | 0 | 0 | 106,353 |
| Short-term investments, net | 0 | 33,784 | 0 |
| Investment in unconsolidated investee | 0 | 0 | 32,499 |
| Call or maturity of: | | | |
| Fixed income, available-for-sale | 32,225 | 10,000 | 0 |
| Cash dividends received-subidiaries | 70,000 | 149,722 | 10,928 |
| Net cash provided by (used in) investing activities | 66,565 | 153,525 | 52,078 |
| Cash flows from financing activities | | | |
| Stock option excess tax benefit | 4,929 | 2,042 | 2,930 |
| Proceeds from stock option exercises | (150) | 2,952 | 3,254 |
| Treasury shares purchased | (47,904) | (131,827) | (37,600) |
| Cash dividends paid | (22,701) | (21,699) | (19,007) |
| Net cash used in financing activities | (65,826) | (148,532) | (50,423) |
| Net (decrease) increase in cash | 374 | (13) | (49) |
| Cash at beginning of year | 1 | 14 | 63 |
| Cash at end of year | \$ 375 | \$ 1 | \$ 14 |

Years ended December 31,

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Interest paid on outstanding debt for 2008, 2007, and 2006 amounted to \$6.0 million. See Notes to Consolidated Financial Statements, as attached in Exhibit 13. See also the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE III SUPPLEMENTARY INSURANCE INFORMATION

As of and for the years ended December 31, 2008, 2007, and 2006

| (in thousands) Segment | Deferred policy Acquisition Costs | Unpaid losses and settlement expenses, gross | Unearned premiums, gross | Net Premiums Earned | Incurred Losses and settlement expenses current year |
|---------------------------------|---|--|--------------------------------|---------------------------|---|
| Year ended December 31, 2008 | | | | | |
| Casualty segment | \$ 31,685 | \$ 1,035,309 | \$ 193,984 | \$ 313,481 | \$ 220,442 |
| Property segment | 23,304 | 101,154 | 95,777 | 146,863 | 80,638 |
| Surety segment | 23,531 | 22,848 | 45,409 | 68,420 | 8,432 |
| RLI Insurance Group | \$ 78,520 | \$ 1,159,311 | \$ 335,170 | \$ 528,764 | \$ 309,512 |
| Year ended December 31, 2007 | | | | | |
| Casualty segment | \$ 35,141 | \$ 1,064,966 | \$ 216,589 | \$ 343,402 | \$ 223,352 |
| Property segment | 21,648 | 99,668 | 97,046 | 138,367 | 62,394 |
| Surety segment | 22,093 | 27,544 | 41,887 | 62,709 | 10,301 |
| RLI Insurance Group | \$ 78,882 | \$ 1,192,178 | \$ 355,522 | \$ 544,478 | \$ 296,047 |
| Year ended December 31, 2006 | | | | | |
| Casualty segment | \$ 33,958 | \$ 1,153,509 | \$ 241,900 | \$ 348,217 | \$ 217,956 |
| Property segment | 19,808 | 117,950 | 107,246 | 122,581 | 70,452 |
| Surety segment | 20,051 | 47,318 | 38,665 | 59,540 | 11,884 |
| RLI Insurance Group | \$ 73,817 | \$ 1,318,777 | \$ 387,811 | \$ 530,338 | \$ 300,292 |

NOTE 1: Investment income is not allocated to the segments, therefore net investment income has not been provided.

See the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE III SUPPLEMENTARY INSURANCE INFORMATION

(continued)

As of and for the years ended December 31, 2008, 2007, and 2006

| (in thousands) Segment | Incurred losses and settlement expenses prior year | Policy acquisition costs | Other operating expenses | Net premiums written |
|------------------------------|--|--------------------------------|--------------------------------|----------------------------|
| Year ended December 31, 2008 | | | | |
| Casualty segment | \$ (50,562) | \$ 76,592 | \$ 20,501 | \$ 295,942 |
| Property segment | (6,646) | 47,491 | 9,568 | 146,089 |
| Surety segment | (5,130) | 39,237 | 5,138 | 71,425 |
| RLI Insurance Group | \$ (62,338) | \$ 163,320 | \$ 35,207 | \$ 513,456 |
| Year ended December 31, 2007 | | | | |
| Casualty segment | \$ (87,397) | \$ 79,618 | \$ 25,967 | \$ 335,401 |
| Property segment | (6,690) | 41,841 | 10,253 | 137,419 |
| Surety segment | (11,092) | 34,151 | 6,015 | 65,943 |
| RLI Insurance Group | \$ (105,179) | \$ 155,610 | \$ 42,235 | \$ 538,763 |
| Year ended December 31, 2006 | | | | |
| Casualty segment | \$ (40,030) | \$ 75,972 | \$ 25,926 | \$ 349,834 |
| Property segment | (1,784) | 37,590 | 11,335 | 139,061 |
| Surety segment | (1,589) | 32,214 | 6,356 | 62,641 |
| RLI Insurance Group | \$ (43,403) | \$ 145,776 | \$ 43,617 | \$ 551,536 |

See the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE IV REINSURANCE

Years ended December 31, 2008, 2007, and 2006

| (in thousands) Segment | Direct amount | Ceded to other companies | Assumed from other companies | Net amount | Percentage of amount assumed to net |
|-------------------------------------|------------------|--------------------------------|------------------------------------|---------------|--|
| 2008 | | | | | |
| Casualty | \$ 429,987 | \$ 111,982 | \$ (4,524) | \$ 313,481 | -1.4% |
| Property | 193,690 | 55,200 | 8,373 | \$ 146,863 | 5.7% |
| Surety | 72,147 | 5,096 | 1,369 | \$ 68,420 | 2.0% |
| RLI Insurance Group Premiums earned | \$ 695,824 | \$ 172,278 | \$ 5,218 | \$ 528,764 | 1.0% |
| 2007 | | | | | |
| Casualty | \$ 484,996 | \$ 144,502 | \$ 2,908 | \$ 343,402 | 0.8% |
| Property | 214,724 | 77,874 | 1,517 | \$ 138,367 | 1.1% |
| Surety | 66,174 | 4,769 | 1,304 | \$ 62,709 | 2.1% |
| RLI Insurance Group Premiums earned | \$ 765,894 | \$ 227,145 | \$ 5,729 | \$ 544,478 | 1.1% |
| 2006 | | | | | |
| Casualty | \$ 510,840 | \$ 165,813 | \$ 3,190 | \$ 348,217 | 0.9% |
| Property | 214,909 | 94,428 | 2,100 | \$ 122,581 | 1.7% |
| Surety | 63,155 | 4,307 | 692 | \$ 59,540 | 1.2% |
| RLI Insurance Group Premiums earned | \$ 788,904 | \$ 264,548 | \$ 5,982 | \$ 530,338 | 1.1% |

See the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE V VALUATION AND QUALIFYING ACCOUNTS

Years ended December 31, 2008, 2007, and 2006

| (in thousands) | Balance at beginning of period | Amounts charged to expense | Amounts recovered (written off) | Balance at end of period |
|--|--------------------------------------|----------------------------------|---------------------------------------|--------------------------------|
| 2008 Allowance for uncollectible reinsurance | \$ 31,421 | \$ 1,416 | \$ (3,626) | \$ 29,211 |
| 2007 Allowance for uncollectible reinsurance | \$ 36,558 | \$ 6,773 | \$ (11,910) | \$ 31,421 |
| 2006 Allowance for uncollectible reinsurance | \$ 36,855 | \$ 2,092 | \$ (2,389) | \$ 36,558 |

See the accompanying report of independent registered accounting firm on page 47 of this report.

RLI CORP. AND SUBSIDIARIES

SCHEDULE VI SUPPLEMENTARY INFORMATION CONCERNING

PROPERTY-CASUALTY INSURANCE OPERATIONS

Years ended December 31, 2008, 2007, and 2006

| (in thousands) Affiliation with Registrant (1) | Deferred Policy Acquisition Costs | Claims and Claim Adjustment Expense Reserves | Unearned Premiums, Gross | Net Premiums Earned | Net Investment Income |
|--|---|--|--------------------------------|---------------------------|-----------------------------|
| 2008 | \$ 78,520 | \$ 1,159,311 | \$ 335,170 | \$ 528,764 | \$ 78,986 |
| 2007 | \$ 78,882 | \$ 1,192,178 | \$ 355,522 | \$ 544,478 | \$ 78,901 |
| 2006 | \$ 73,817 | \$ 1,318,777 | \$ 387,811 | \$ 530,338 | \$ 71,325 |

| | Claims and Claim Adjustment Expenses Incurred Related to: | | Amortization of Deferred Acquisition Costs | Paid Claims and Claim Adjustment Expenses | Net Premiums Written |
|------|--|---------------|--|---|----------------------------|
| | Current Year | Prior Year | | | |
| 2008 | \$ 309,512 | \$ (62,338) | \$ 163,320 | \$ 213,075 | \$ 513,456 |
| 2007 | \$ 296,047 | \$ (105,179) | \$ 155,610 | \$ 209,046 | \$ 538,763 |
| 2006 | \$ 300,292 | \$ (43,403) | \$ 145,776 | \$ 202,440 | \$ 551,536 |

(1) Consolidated property-casualty insurance operations.

See the accompanying report of independent registered accounting firm on page 47 of this report.

EXHIBIT INDEX

| Exhibit No. | Description of Document | Reference (page) |
|--------------------|---|--|
| 3.1 | Amended and Restated Articles of Incorporation | Incorporated by reference to the Company's Form 8-K filed May 8, 2008. |
| 3.2 | Restated By-Laws | Incorporated by reference to the Company's Form 8-K filed November 18, 2008. |
| 4.1 | Senior Indenture dated as of December 9, 2003 | Incorporated by reference to the Company's Form 8-K filed December 10, 2003. |
| 10.1 | The RLI Corp. Directors' Irrevocable Trust Agreement | Incorporated by reference to the Company's Quarterly Form 10-Q for the Second Quarter ended June 30, 1993. |
| 10.2 | RLI Corp. Incentive Stock Option Plan | Incorporated by reference to Company's Registration Statement on Form S-8 filed on March 11, 1996, File No. 333-01637. |
| 10.3 | Directors' Stock Option Plan | Incorporated by reference to the Company's Registration Statement on Form S-8 filed on June 6, 1997, File No. 333-28625. |
| 10.5 | RLI Corp. Nonemployee Directors' Deferred Compensation Plan, as amended | Attached as Exhibit 10.5. |
| 10.6 | RLI Corp. Executive Deferred Compensation Plan, as amended | Attached as Exhibit 10.6. |
| 10.7 | Key Employee Excess Benefit Plan, as amended | Attached as Exhibit 10.7. |
| 10.8 | RLI Corp. Omnibus Stock Plan | Incorporated by reference to the Company's Registration Statement on Form S-8 filed on May 31, 2005, File No. 333-125354. |
| 10.9 | RLI Incentive Compensation Plan, as amended | Attached as Exhibit 10.9. |
| 11.0 | Statement re: computation of per share earnings | Refer to the Note 1P, Earnings per share, on page 37 of the 2008 Financial Report to Shareholders, attached as Exhibit 13. |
| 13.0 | 2008 Financial Report to Shareholders | Attached as Exhibit 13. |

EXHIBIT INDEX

| Exhibit No. | Description of Document | Reference Page |
|--------------------|--|-----------------------|
| 21.1 | Subsidiaries of the Registrant | Page 59 |
| 23.1 | Consent of KPMG LLP | Page 60 |
| 31.1 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | Page 61 |
| 31.2 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | Page 62 |
| 32.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Page 63 |
| 32.2 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Page 64 |