

MANAGEMENT'S DISCUSSION AND ANALYSIS

OVERVIEW

RLI Corp. underwrites selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group. 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 commercial earthquake coverage 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 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.

The foundation of our overall business strategy is to underwrite for profit, and we have achieved this for 11 consecutive years averaging a 90.5 combined ratio over that period of time. This drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio, and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly rated, investment grade securities to protect invested assets. Regular underwriting income allows a portion of our shareholders' equity to be invested in value-based equities, including a core portfolio weighted toward dividend-paying stocks,

including REITs. Private equity investments, primarily our minority ownership in Maui Jim, Inc. (Maui Jim), have also enhanced overall returns. Additional asset classes for diversification are also being considered. 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 occasional fluctuations of realized and unrealized gains and losses in the equity portfolio, our investment in stocks as part of a long-term asset allocation strategy has contributed significantly to our historic growth in book value.

We measure the results of our insurance operations by monitoring certain measures of growth and profitability across three distinct business segments: casualty, property, and surety. Growth is measured in terms of gross premiums written and profitability is analyzed through combined ratios, which are further subdivided into their respective loss and expense components. The combined ratios represent the income generated from our individual segments.

The casualty portion of our business consists largely of general liability, transportation, multi-peril program business, commercial umbrella, personal umbrella, executive products, and other specialty coverages. In addition, we provide employers' indemnity and in-home business owners coverage. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty segment may also be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

Our property segment primarily underwrites commercial fire, earthquake, difference in conditions, marine, and in the state of Hawaii, select personal lines policies. Property insurance results are subject to the variability introduced by perils such as earthquakes, fires, and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily in the state of California. Our second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes we insure in Hawaii. We limit our net aggregate

exposure to a catastrophic event by purchasing reinsurance and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

The 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. Our surety coverages usually involve a statutory requirement for bonds. While these bonds have maintained a relatively low loss ratio, losses may fluctuate due to adverse economic conditions that may affect the financial viability of an insured. The contract surety marketplace guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic conditions, inclement weather conditions or the deterioration of a contractor's financial condition. As such, this line has historically produced marginally higher loss ratios than other surety lines.

The insurance marketplace softened over the last three years, meaning that the marketplace became more competitive and prices were generally flat to falling, even as coverage terms became less restrictive. Nevertheless, we believe that our business model is geared to create underwriting income by focusing on sound underwriting discipline. Our primary focus will continue to be on underwriting profitability as opposed to premium growth or market share measurements.

GAAP AND NON-GAAP FINANCIAL PERFORMANCE METRICS

Throughout this annual report, 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 we believe are valuable in managing our business and drawing comparisons to our peers. These measures are underwriting income, gross premiums written, net premiums written, combined ratios, and net unpaid loss and settlement expenses.

Following is a list of non-GAAP measures found throughout this report with their definitions,

relationships to GAAP measures, and explanations of their importance to our operations.

Underwriting Income

Underwriting income or profit represents the pretax profitability of our insurance operations and is derived by subtracting losses and settlement expenses, policy acquisition costs, and insurance operating expenses from net premium earned. Each of these captions is presented in the statements of earnings but not subtotaled. However, this information is available in total and by segment in note 11 to the financial statements, regarding industry segment information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, general corporate expenses, debt costs, and unconsolidated investee earnings.

Gross premiums written

While net premiums earned is the related GAAP measure used in the statements of earnings, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in our insurance underwriting operations with some indication of profit potential subject to the levels of our retentions, expenses, and loss costs.

Net premiums written

While net premiums earned is the related GAAP measure used in the statements of earnings, net premiums written is the component of net premiums earned that measures the difference between gross premiums written and the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in our insurance underwriting operations. It is an indicator of future earnings potential subject to our expenses and loss costs.

Combined ratios

This ratio is a common industry measure of profitability for any underwriting operation, and is calculated in two components. First, the loss ratio is losses and

settlement expenses divided by net premiums earned. The second component, the expense ratio, reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss. For example, a combined ratio of 85 implies that for every \$100 of premium we earn, we record \$15 of underwriting income.

Net unpaid loss and settlement expenses

Unpaid losses and settlement expenses, as shown in the liabilities section of our balance sheet, represents the total obligations to claimants for both estimates of known claims and estimates for incurred but not reported (IBNR) claims. The related asset item, reinsurance balances recoverable on unpaid losses and settlement expense, is the estimate of known claims and estimates of IBNR that we expect to recover from reinsurers. The net of these two items is generally referred to as net unpaid loss and settlement expenses and is commonly referred to in our disclosures regarding the process of establishing these various estimated amounts.

In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates.

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation, recoverability of reinsurance balances, and deferred policy acquisition costs.

CRITICAL ACCOUNTING POLICIES

LOSSES AND SETTLEMENT EXPENSES

Overview

Loss and loss adjustment expense 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 with periodic review by outside independent actuarial firms.

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 loss adjustment expense 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 events 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 will 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 loss adjustment expense reserves — case-specific reserves and incurred but not reported (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 Incurred But Not Reported (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 loss adjustment expense 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.

Loss adjustment expense (LAE) represents the cost involved in adjusting and administering losses from policies we sold. 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 the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, vice president of claims, vice president of underwriting, 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, 2006, make a reasonable provision to meet our future obligations.

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 allocated loss adjustment expense 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 twelve 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.

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 performance adjusted for price change and loss cost inflation. The initial loss and ALAE ratios also reflect 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,
- consisting of a new business,
- undergoing significant exposure growth or 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.

The historical and prospective loss and ALAE estimates along with the applicable risk factors identified above are the bases 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 and prevailing risk factors. The Loss Reserve Committee makes all final decisions regarding changes in the initial loss and ALAE ratios.

Loss and LAE Reserve Estimating 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 loss adjustment expense 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 actuarial 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 loss adjustment expense 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 loss adjustment expense 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.

Our estimates of ultimate loss and LAE reserves are subject to change as additional data emerge. 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 their 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 the various qualified experts may differ materially from each other. We consider this uncertainty by examining our historic reserve accuracy.

Given the significant impact of the reserve estimates on our financial statements, we subject the reserving process to significant diagnostic testing and outside review. Multiple outside reserving specialists periodically review the reserve estimation process and the resulting estimates. We give consideration to these outside opinions and implement recommended improvements as deemed appropriate. We have incorporated data validity checks and balances into our front-end processes. 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 loss adjustment expense estimation analysis, the results are discussed with the Loss Reserve Committee (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. Review of the 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 that 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 large variation is the above average policyholder turnover and changes in the underlying mix of exposures typical of all 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 what 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 in an amount above what 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 update them by adopting industry best practices where appropriate. No significant changes were made in 2006.

INVESTMENT VALUATION

Throughout each year, we and our investment managers buy and sell securities to maximize overall investment returns in accordance with investment policies established and monitored by our board of directors and officers. This includes selling available-for-sale securities that have unrealized gains or losses when it is believed that future performance can be improved by buying other securities deemed to offer superior long-term return potential.

We classify our investments in debt and equity securities with readily determinable fair values into one of three categories. Held-to-maturity securities are carried at amortized cost. Available-for-sale securities are carried at fair value with unrealized gains/losses recorded as a component of comprehensive earnings and shareholders’ equity, net of deferred income taxes. Trading securities are carried at fair value with unrealized gains/losses included in earnings.

We regularly evaluate our fixed maturity and equity securities portfolio to determine impairment losses for other-than-temporary declines in the fair value of the investments. Criteria considered during this process include, but are not limited to: the current fair value as compared to the cost (amortized, in certain cases) of the security, degree and duration of the security’s fair value being below cost, credit quality, current economic conditions, the anticipated speed of cost recovery, and our decisions to hold or divest a security. Part of our evaluation of whether particular securities are other-than-temporarily impaired involves assessing whether we have both the intent and ability to continue to hold securities in an unrealized loss position. Impairment losses result in

a reduction of the underlying investment's cost basis. Significant changes in these factors could result in a considerable charge for impairment losses.

RECOVERABILITY OF REINSURANCE BALANCES

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, rather than being netted with the related liabilities, since reinsurance does not relieve us of our liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. Additionally, the same uncertainties associated with estimating unpaid losses and settlement expenses impact the estimates for the ceded portion of such liabilities. We continually monitor the financial condition of our reinsurers. Our policy is to periodically charge to earnings an estimate of unrecoverable amounts from reinsurers. Further discussion of the security of our recoverable reinsurance balances can be found in note 5 to the financial statements.

DEFERRED POLICY ACQUISITION COSTS

We defer commissions, premium taxes, and certain other costs that vary with and are primarily related to the acquisition of insurance contracts. Acquisition-related costs may be deemed ineligible for deferral when they are based on contingent or performance criteria beyond the basic acquisition of the insurance contract. All eligible costs are capitalized and charged to expense in proportion to premium revenue recognized. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. This would also give effect to the premiums to be earned and anticipated losses and settlement expenses, as well as certain other costs expected to be incurred as the premiums are earned. Judgments as to the ultimate recoverability of such deferred costs are highly dependent upon estimated future loss costs associated with the premiums written. This deferral methodology applies to both gross and ceded premiums and acquisition costs.

Additional discussion of other significant accounting policies may be found in note 1 to the financial statements.

RESULTS OF OPERATIONS

Consolidated revenue for 2006 was \$632.7 million compared to \$569.3 million in 2005 and \$578.8 million in 2004. The drop in 2005 resulted largely from the decline in net premiums earned in the property segment. The current year benefited from gains in both the insurance operations' premiums earned as well as the increase in net investment income. Realized gains also increased largely due to the sale of the equity in one of our investee holdings.

Consolidated revenue (in thousands)

Year ended December 31,	2006	2005	2004
Net premiums earned	\$530,338	\$491,307	\$511,348
Net investment income	71,325	61,641	54,087
Net realized investment gains	31,045	16,354	13,365
Total consolidated revenue	\$632,708	\$569,302	\$578,800

Net earnings reached an all-time high as increases were achieved in underwriting, investments and investee earnings. Debt interest declined as the amount outstanding was reduced in 2006. General corporate expenses moved up each of the last two years from increased director's fees and legal costs, as well as increases in compensation related to financial performance.

Net earnings (in thousands)

	2006	2005	2004
Underwriting income	\$ 84,056	\$ 68,883	\$ 39,891
Net investment income	71,325	61,641	54,087
Net realized investment gains	31,045	16,354	13,365
Debt interest	(6,581)	(7,118)	(6,894)
Corporate expenses	(8,069)	(6,780)	(5,536)
Investee earnings	15,117	10,896	5,429
Pretax earnings	\$186,893	\$143,876	\$100,342
Income tax	(52,254)	(36,742)	(27,306)
Net earnings	\$134,639	\$107,134	\$ 73,036

Comprehensive earnings were \$157.0 million in 2006 compared to \$83.9 million a year ago and \$81.4 million in 2004. For the equity portfolio, the change in unrealized gains was positive in 2006 and 2004, while the change was negative in 2005. In the bond portfolio, the unrealized change was positive in 2006, while the unrealized change was negative in both 2005 and 2004.

RLI INSURANCE GROUP

In general, we have experienced continued softening in the marketplace over the last three years. While the year did show moderate growth overall, the property segment saw significant premium increases through the first three quarters of 2006 as rates were up markedly in catastrophe-prone areas. Underwriting income was up considerably in our insurance operations. The casualty segment posted similar results to that of 2005 while the property segment benefited from a light hurricane season and reported underwriting income, compared to a loss in 2005. The surety segment continued its trend of growing profitability by more than doubling the 2005 result. The following table and narrative provide a more detailed look at individual segment performance over the last three years.

Gross premiums written (in thousands)	2006	2005	2004
Casualty	\$506,887	\$519,115	\$519,817
Property	225,610	176,228	178,625
Surety	66,516	60,669	54,146
Total	\$799,013	\$756,012	\$752,588

Underwriting income (loss) (in thousands)	2006	2005	2004
Casualty	\$ 68,393	\$ 72,024	\$ 19,560
Property	4,988	(8,342)	20,400
Surety	10,675	5,201	(69)
Total	\$ 84,056	\$ 68,883	\$ 39,891

Combined ratio	2006	2005	2004
Casualty	80.4	80.0	94.7
Property	95.9	110.3	79.2
Surety	82.1	90.0	100.2
Total	84.1	86.0	92.2

The following table further summarizes revenues (net premiums earned) by major coverage type within each segment:

(in thousands)	2006	2005	2004
Casualty			
General liability	\$180,037	\$180,267	\$174,954
Commercial and personal umbrella	64,730	59,847	53,478
Executive coverages	13,040	9,807	13,074
Specialty program business	25,507	38,289	47,072
Commercial transportation	48,285	51,707	55,994
Other	16,618	18,976	21,045
Total	\$348,217	\$358,893	\$365,617
Property			
Commercial property	\$ 91,507	\$ 66,410	\$ 69,169
Construction	4,493	2,521	21,633
Marine	16,785	3,286	-
Other property	9,796	8,311	7,241
Total	\$122,581	\$ 80,528	\$ 98,043
Surety	\$ 59,540	\$ 51,886	\$ 47,688
Grand total	\$530,338	\$491,307	\$511,348

Casualty

Casualty gross premiums written were down 2.4 percent in 2006 while virtually flat from 2004 to 2005. Only the umbrella and executive products experienced growth while all other lines were down by varying degrees as marketplace conditions for this segment continued to soften. Despite competitive pressures, we remained disciplined in writing only those accounts which we believe will provide adequate returns. This soft marketplace is likely to continue suppressing premium growth in 2007.

The 80.4 combined ratio for the casualty segment in 2006 was almost unchanged from the 2005 measure of 80.0. In each of these years, actuarial studies indicated that cumulative experience attributable to some casualty coverages for mature accident years was considerably lower than the reserves booked. Therefore, reserves were released in the amounts of \$39.3 million and \$51.8 million for 2006 and 2005, respectively. While we had been experiencing robust price improvements in this segment the last several years, we also produced significant new business with new exposures. Our reserving evaluation process requires adequate

time periods to elapse to assess the impact of such changes in marketplace conditions on our book of casualty business.

Property

Gross premiums written in the property segment rose 28.0 percent in 2006 compared to declines of 1.3 percent in 2005 and 7.6 percent in 2004. The turnaround occurred as a result of considerable rate increases in hurricane and earthquake-prone areas while our actual exposure to these events declined. Additionally, the marine division that launched in 2005 contributed increased gross premiums written of \$16.2 million in 2006. In 2005, we experienced a significant decline in our construction coverage, which we exited during the fourth quarter of that year. Earthquake coverage premiums had dropped in 2005 as we focused on reducing our exposure. Segment revenues for 2005 decreased disproportionately as we incurred charges of approximately \$10.0 million to meet minimum reinsurance premium requirements as well as to reinstate reinsurance coverage exhausted by loss activity on our construction coverage. Revenue bounced back in 2006, increasing by 52.2 percent.

Underwriting income was \$5.0 million in 2006 compared to a loss of \$8.3 million in 2005 and income of \$20.4 million in 2004. Although we experienced a light hurricane season in 2006, other catastrophe losses such as tornadoes and hailstorms, along with increased severity of commercial fire losses, served to hamper the segment's profitability. Favorable loss reserve development from the two prior years' hurricane reserves contributed \$4.2 million to profits in 2006. However, additional charges were incurred from the run-off of the previously exited construction coverage, which amounted to \$13.7 million this year compared to charges of \$13.5 million in 2005. The 2005 results were affected by the second straight year of severe hurricane activity, which negatively impacted the segment by \$22.3 million. While the property charge in 2004 from hurricane activity was \$10.1 million, there was some favorable development of those reserves in 2005 which provided a benefit of \$2.2 million.

Surety

Surety gross premiums written increased for the third straight year. As was the case in 2005, all the

major coverages in this segment produced increases in 2006. Total segment revenue followed suit, improving by 14.8 percent in 2006 compared to 8.8 percent and 2.8 percent in 2005 and 2004, respectively.

Underwriting income more than doubled in the surety segment in 2006 totalling \$10.7 million compared to \$5.2 million in 2005. These results reflect the benefit of re-underwriting efforts initiated during 2003 and 2004. Favorable development on prior accident years' loss reserves resulted in a benefit of \$2.6 million in 2006 and \$2.1 million in 2005.

We are in litigation regarding certain commercial surety bond claims arising out of a specific bond program. We believe we have meritorious defenses to these claims and are vigorously asserting our positions in pending legal actions in multiple jurisdictions. See note 10 for further discussion.

NET INVESTMENT INCOME AND REALIZED INVESTMENT GAINS

During 2006, net investment income increased by 15.7 percent due to continued positive operating cash flow. On an after-tax basis, net investment income increased by 13.9 percent. Operating cash flows were \$171.8 million in 2006, compared to \$198.0 million in 2005, and \$189.0 million in 2004. The average annual yields on our investments were as follows for 2006, 2005, and 2004:

	2006	2005	2004
Pretax yield			
Taxable (on book value)	5.22%	4.90%	4.92%
Tax-exempt (on book value)	4.02%	3.98%	4.10%
Equities (on fair value)	2.78%	2.80%	3.26%
After-tax yield			
Taxable (on book value)	3.40%	3.19%	3.20%
Tax-exempt (on book value)	3.81%	3.77%	3.88%
Equities (on fair value)	2.39%	2.40%	2.79%

The after-tax yield reflects the different tax rates applicable to each category of investment. Our taxable bonds are subject to our corporate tax rate of 35 percent, our tax-exempt municipal bonds are subject to a tax rate of 5.3 percent and our dividend income is generally subject to a tax rate of 14.2 percent. During 2006, the average after-tax yield of the fixed income portfolio increased to 3.55 percent from 3.43 percent

in 2005 due to an increase in taxable and tax-exempt yields on new purchases. During the year, we focused on purchasing high-quality investments, including U.S. government and agency securities, municipal bonds, mortgage-backed securities, and asset-backed securities, primarily in the 5-15 year range of the yield curve.

The fixed income portfolio increased by \$24.4 million during the year. This portfolio had net realized losses of \$7.3 million and a tax-adjusted total return on a mark-to-market basis of 5.3 percent. Our equity portfolio increased by \$47.1 million during 2006, to \$368.2 million. For the year, this portfolio had an unrealized gain of \$32.1 million and realized gains of \$38.6 million. The total return for the year on the equity portfolio was 21.0 percent.

Our investment results for the last five years are shown in the following table:

(in thousands)	Average Invested Assets ⁽¹⁾	Net Investment Income ⁽²⁾⁽³⁾	Net Realized Gains (Losses) ⁽³⁾	Change in Unrealized Appreciation ⁽³⁾⁽⁴⁾	Annualized Return on Avg. Invested Assets	Tax Equivalent Annualized Return on Avg. Invested Assets
2002	\$ 896,785	\$37,640	\$ (3,552)	\$(34,091)	0.0%	0.7%
2003	1,166,694	44,151	12,138	40,096	8.3%	9.0%
2004	1,451,539	54,087	13,365	13,200	5.6%	6.3%
2005	1,633,755	61,641	16,354	(35,788)	2.6%	3.3%
2006	1,763,016	71,325	31,045	34,395	7.8%	8.6%
5-yr Avg.	\$1,382,358	\$53,769	\$13,870	\$ 3,562	4.9%	5.6%

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

⁽²⁾ Investment income, net of investment expenses, including non-debt interest expense.

⁽³⁾ Before income taxes.

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

We realized \$31.0 million in capital gains in 2006, compared to capital gains of \$16.4 million in 2005 and \$13.4 million in 2004. Results for 2006 included a \$16.2 million gain from the sale of our equity in Taylor, Bean & Whitaker Mortgage Corp. (TBW) as discussed in note 1 to the financial statements. Other gains resulted from routine investment management decisions regarding relative valuation, fundamental analysis, and market conditions.

We regularly evaluate the quality of our investment portfolio. When we believe that a specific security has suffered an other-than-temporary decline in value, the investment's value is adjusted by reclassifying the

decline from unrealized to realized losses. This has no impact on shareholders' equity. There have been no losses associated with the other-than-temporary impairment of securities in 2006, 2005, or 2004. The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of December 31, 2006, including fair value, cost basis, and unrealized gains and losses.

(in thousands)	Cost Basis	12/31/06 Fair Value	Gross Unrealized Gains	Unrealized Losses	Unrealized Gain/ Loss ⁽¹⁾	Net
Consumer discretionary	\$ 12,750	\$ 16,663	\$ 4,055	\$(142)	\$ 3,913	30.7%
Consumer staples	16,331	32,616	16,293	(8)	16,285	99.7%
Energy	7,968	29,038	21,070	-	21,070	264.4%
Financials	27,287	67,083	39,796	-	39,796	145.8%
Healthcare	12,950	30,064	17,158	(44)	17,114	132.2%
Industrials	16,816	38,432	21,711	(95)	21,616	128.5%
Materials	6,515	8,757	2,382	(140)	2,242	34.4%
Information technology	11,705	19,885	8,278	(98)	8,180	69.9%
Telecommunications	7,015	15,582	8,567	-	8,567	122.1%
Utilities	45,958	73,331	27,373	-	27,373	59.6%
Other	36,148	36,744	596	-	596	1.6%
Total	\$201,443	\$368,195	\$167,279	\$(527)	\$166,752	82.8%

⁽¹⁾ Calculated as the percentage of net unrealized gain (loss) to cost basis

As of December 31, 2006, we held seven common stocks that were in unrealized loss positions. The total unrealized loss on these securities was \$0.5 million. All of these securities have been in an unrealized loss position for less than nine months.

The fixed income portfolio contained 412 positions at a loss as of December 31, 2006. Of these 412 securities, 248 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent \$10.5 million in unrealized losses. The fixed income unrealized losses can be primarily attributed to changes in interest rates from the time of purchase. We continually monitor the credit quality of our fixed income investments to gauge our ability to be repaid 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. Credit ratings from major rating agencies, including Moody's and Standard & Poor's,
2. Business and operating performance trends,
3. Management quality/turnover,
4. Industry competitive analysis, and
5. Changes in business model/strategy.

As of December 31, 2006, we held no equity or fixed income securities that individually had an unrealized loss greater than 12 percent. Based on our evaluation of equity securities held within specific industry sectors, as well as the duration and magnitude of unrealized losses in our equity and bond portfolios, we do not believe any securities suffered an other-than-temporary decline in value as of December 31, 2006.

The amortized cost and estimated fair value of fixed-maturity securities at December 31, 2006, by contractual maturity, are shown as follows:

(in thousands)	Amortized Cost	Estimated Fair Value
Total fixed income		
Due in one year or less	\$ 18,999	\$ 19,105
Due after one year through five years	317,934	318,154
Due after five years through 10 years	640,809	640,532
Due after 10 years	383,713	380,470
Total	\$1,361,455	\$1,358,261

Expected maturities may differ from contractual maturities due to call provisions on some existing securities.

INTEREST AND GENERAL CORPORATE EXPENSE

Interest on debt fell 7.5 percent as short-term obligations were paid off during the year. While debt interest was basically flat in 2005, the 2004 increase resulted from the issuance of \$100 million in 10-year maturity senior notes in December 2003. Decisions regarding future short-term debt management will be based on available cash flow and the interest rate environment. General corporate expenses tend to fluctuate relative to our executive compensation plan and have increased in each of the last three years due to strong operating results. This model measures

comprehensive earnings against a minimum required return on our capital. Additionally, legal fees, director fees, and travel rose since 2003.

INVESTEE EARNINGS

We maintain a 40 percent interest in Maui Jim, primarily a manufacturer of high-quality polarized sunglasses. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim. In 2006 we recorded \$8.8 million in earnings from this investment compared to \$8.4 million in 2005 and \$5.0 million in 2004. The upward trend over the last two years is the result of improved operating performance. Also included in this caption were \$6.3 million, \$2.5 million, and \$0.5 million in earnings over the last three years from our investment in TBW. During the fourth quarter of 2004, we converted warrants to common stock in this private mortgage origination company, which increased our ownership interest to 21 percent. Prior to the conversion, earnings from this ownership were reflected in net investment income. In the fourth quarter of this year, we sold our equity in TBW for \$32.5 million resulting in a pretax realized gain of \$16.2 million.

INCOME TAXES

Our effective tax rates were 28.0 percent, 25.5 percent, and 27.2 percent for 2006, 2005, and 2004, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2006 was higher than 2005 and 2004 due to the increase in underwriting income and net realized gains, which were taxed at 35.0 percent. Partially offsetting this increase, results for 2006 included the favorable resolution of a recent tax examination. During 2006, the Internal Revenue Service (IRS) concluded an examination of our tax years 2000 through 2004. As a result of this exam, we recorded a \$3.2 million tax benefit, resulting from a change in tax estimate related to the sale of assets. In 2006 and 2005, a tax benefit was realized associated with a dividend declared and payable in 2007 and 2006, respectively, from an unconsolidated investee, Maui Jim. As required under Statement of Financial Accounting Standards (SFAS) 109, "Accounting for Income Taxes," the gain reflects the tax benefit of applying the lower tax rate applicable to affiliated dividends (7 percent) as compared to the corporate capital gains tax rate (35 percent) on which

previous tax estimates were based. In addition, our pretax earnings in 2006 included \$28.7 million of investment income that is wholly or partially exempt from federal income tax, compared to \$28.2 million and \$25.2 million in 2005 and 2004, respectively.

NET UNPAID LOSSES AND SETTLEMENT EXPENSES

The primary liability on our balance sheet relates to unpaid losses and settlement expenses, which represents our estimated liability for losses and related settlement expenses before considering offsetting reinsurance recoverable balances. This liability can be further deconstructed into two parts: (1) case reserves representing estimates of losses and settlement expenses on known claims and (2) IBNR — incurred but not reported — reserves representing estimates of losses and settlement expenses on claims that have occurred but have not yet been reported to us. Our gross liability for both case and IBNR reserves is reduced by reinsurance balances recoverable on unpaid losses and settlement expenses to calculate our net reserve balance. This net reserve balance increased from \$738.7 million at December 31, 2005, to \$793.1 million as of December 31, 2006. This reflects incurred loss of \$256.9 million in 2006 offset by paid losses of \$202.4 million, compared to incurred losses of \$251.2 million offset by \$180.9 million paid in 2005. As of December 31, 2006, our net IBNR reserves represented 64.3 percent of total net reserves while the remainder was for case reserves. As of December 31, 2005, IBNR net reserves represented 63.3 percent of total net reserves.

MARKET RISK DISCLOSURE

Market risk is a general term describing the potential economic loss associated with adverse changes in the fair value of financial instruments. Management of market risk is a critical component of our investment decisions and objectives. We manage our exposure to market risk by using the following tools:

1. Monitoring the fair value of all financial assets on a constant basis,
2. Changing the character of future investment purchases as needed, and
3. Maintaining a balance between existing asset and liability portfolios.

INTEREST RATE RISK

Our primary exposure to interest rate risk is with our fixed income investment portfolio.

Modified duration analysis is used to measure the sensitivity of the fixed income portfolio to changes in interest rates, providing a measure of price percentage volatility. We attempt to minimize interest rate risk by matching the duration of assets to that of liabilities.

Interest rate risk will also affect our income statement due to its impact on interest expense. We maintain a debt obligation that is long term in nature. At the end of 2005, our short-term debt was \$15.5 million. As of December 31, 2006, our short-term debt obligations were zero. Our long-term debt carries a fixed interest rate. As such, our interest expense on this obligation is not subject to changes in interest rates. As this debt is not due until 2014, we will not assume risk in our ability to refinance this debt for many years.

EQUITY PRICE RISK

Equity price risk is the potential that we will incur economic loss due to the decline of common stock prices. Beta analysis is used to measure the sensitivity of our equity portfolio to changes in the value of the S&P 500 Index (an index representative of the broad equity market). Our current equity portfolio has a beta of .72 in comparison to the S&P 500. Our equity investment returns have been similar to the S&P 500 with much less volatility. This low beta statistic reflects our long-term emphasis on maintaining a conservative, value oriented, dividend-driven investment philosophy for our equity portfolio. Historically, dividend-paying common stocks have demonstrated superior down-market performance characteristics.

SENSITIVITY ANALYSIS

The tables on page 14 detail information on the market risk exposure for our financial investments as of December 31, 2006. Listed on each table is the December 31, 2006, fair value for our assets and the expected pretax reduction in fair value given the stated hypothetical events. This sensitivity analysis assumes the composition of our assets remains constant over the period being measured and also assumes interest rate changes are reflected uniformly across the yield curve. For example, our ability to

hold non-trading securities to maturity mitigates price fluctuation. For purposes of this disclosure, market-risk-sensitive instruments are divided into two categories: instruments held for trading purposes and those held for nontrading purposes. The examples given are not predictions of future market events, but rather illustrations of the effect such events may have on the fair value of our investment portfolio.

As of December 31, 2006, our fixed income portfolio had a fair value of \$1.4 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2006, levels with all other variables held constant. Such scenarios would result in decreases in the fair value of the fixed income portfolio of \$61.8 million and \$123.9 million, respectively. Due to our use of the held-to-maturity designation for a portion of the fixed income portfolio, the balance sheet impact of these scenarios would be lower.

As of December 31, 2006, our equity portfolio had a fair value of \$368.2 million. The base sensitivity analysis uses market scenarios of the S&P 500 Index declining both 10 percent and 20 percent. These scenarios would result in approximate decreases in the equity fair value of \$29.9 million and \$59.9 million, respectively. As we designate all common stocks as available-for-sale, these fair value declines would impact our balance sheet.

Counter to the base scenarios shown in Tables 1 and 2, Tables 3 and 4 quantify the opposite impact. Under the assumptions of falling interest rates and an increasing S&P 500 Index, the fair value of our assets will increase from their present levels by the indicated amounts.

Table 1 (in thousands)
Effect of a 100-basis-point increase in interest rates and a 10% decline in the S&P 500:

	12/31/06 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 14,960	\$ (622)	\$ -
Total trading	14,960	(622)	-
Held for nontrading purposes			
Fixed maturity securities	1,343,301	(61,132)	-
Equity securities	368,195	-	(29,971)
Total nontrading	\$1,711,496	(61,132)	(29,971)
Total trading & nontrading	\$1,726,456	\$(61,754)	\$(29,971)

Table 2 (in thousands)
Effect of a 200-basis-point increase in interest rates and a 20% decline in the S&P 500:

	12/31/06 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 14,960	\$ (1,216)	\$ -
Total trading	14,960	(1,216)	-
Held for nontrading purposes			
Fixed maturity securities	1,343,301	(122,698)	-
Equity securities	368,195	-	(59,942)
Total nontrading	\$1,711,496	(122,698)	(59,942)
Total trading & nontrading	\$1,726,456	\$(123,914)	\$(59,942)

Table 3 (in thousands)
Effect of a 100-basis-point decrease in interest rates and a 10% increase in the S&P 500:

	12/31/06 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 14,960	\$ 579	\$ -
Total trading	14,960	579	-
Held for nontrading purposes			
Fixed maturity securities	1,343,301	48,904	-
Equity securities	368,195	-	29,971
Total nontrading	\$1,711,496	48,904	29,971
Total trading & nontrading	\$1,726,456	\$49,483	\$29,971

Table 4 (in thousands)
Effect of a 200-basis-point decrease in interest rates and a 20% increase in the S&P 500:

	12/31/06 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed maturity securities	\$ 14,960	\$ 1,103	\$ -
Total trading	14,960	1,103	-
Held for nontrading purposes			
Fixed maturity securities	1,343,301	95,672	-
Equity securities	368,195	-	59,942
Total nontrading	\$1,711,496	95,672	59,942
Total trading & nontrading	\$1,726,456	\$96,775	\$59,942

LIQUIDITY AND CAPITAL RESOURCES

OVERVIEW

We have three primary types of cash flows: (1) operating cash flows, which consist mainly of cash generated by our underwriting operations and income earned on our investment portfolio, (2) investing cash flows related to the purchase, sale, and maturity of investments, and (3) financing cash flows that impact our capital structure, such as changes in debt and shares outstanding. The following table summarizes these three cash flows over the last three years.

(in thousands)	2006	2005	2004
Operating cash flows	\$171,775	\$ 198,027	\$ 188,962
Investing cash flows	(63,325)	(152,907)	(177,189)
Financing cash flows	(108,450)	(45,120)	(11,773)

Our balance sheet does not reflect any cash balance because all of our funds are invested in short-term investments, primarily highly rated money market instruments.

We have entered into certain contractual obligations that require us to make recurring payments. The following table summarizes our contractual obligations as of December 31, 2006.

(in thousands)	Total	Payments due by period			
		Less than 1 yr.	1-3 yrs.	3-5 yrs.	More than 5 yrs.
Contractual Obligations					
Loss and settlement expense	\$1,318,777	\$407,951	\$499,318	\$232,630	\$178,878
Long-term debt	100,000	-	-	-	100,000
Short-term debt	-	-	-	-	-
Capital lease	192	178	14	-	-
Operating lease	14,187	3,338	5,178	3,688	1,983
Total	\$1,433,156	\$411,467	\$504,510	\$236,318	\$280,861

Loss and settlement expense reserves represent management's best estimate of the ultimate cost of settling reported and unreported claims and related expenses. As discussed previously, the estimation of loss and loss expense reserves is based on various complex and subjective judgments. Actual losses and settlement expenses paid may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements. Similarly, the timing for payment of our estimated losses is not fixed and is not determinable on an individual or aggregate basis.

The assumptions used in estimating the payments due by periods are based on our historical claims payment experience. Due to the uncertainty inherent in the process of estimating the timing of such payments, there is a risk that the amounts paid in any period can be significantly different than the amounts disclosed above. Amounts disclosed above are gross of anticipated amounts recoverable from reinsurers. Reinsurance balances recoverable on unpaid loss and settlement reserves are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not discharge us of our liability to policyholders. Amounts recoverable from reinsurers on unpaid loss and settlement reserves totaled \$525.7 million at December 31, 2006.

The next largest contractual obligation relates to long-term debt outstanding. On December 12, 2003, we completed a public debt offering, issuing \$100 million in senior notes maturing January 15, 2014 (a 10-year maturity), and paying interest semi-annually at the rate of 5.95 percent. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. These notes are rated Baa2 by Moody's and BBB+ by Standard & Poor's. We are not party to any off-balance sheet arrangements.

Our primary objective in managing our capital is to preserve and grow shareholders' equity and statutory surplus to improve our competitive position and allow for expansion of our insurance operations. Our insurance subsidiaries must maintain certain minimum capital levels in order to meet the requirements of the states in which we are regulated. Our insurance companies are also evaluated by rating agencies that assign financial strength ratings that measure our ability to meet our obligations to policyholders over an extended period of time.

We have historically grown our shareholders' equity and/or policyholders' surplus as a result of three sources of funds: (1) earnings on underwriting and investing activities, (2) appreciation in the value of our invested assets, and (3) the issuance of common stock and debt.

At December 31, 2006, we had short-term investments and other investments maturing within one year of approximately \$123.2 million and investments of \$440.0 million maturing within five years. We maintain revolving lines of credit with two financial institutions, each of which permits us

to borrow up to an aggregate principal amount of \$10.0 million. Under certain conditions, each of the lines may be increased up to an aggregate principal amount of \$20.0 million. These facilities have three-year terms that expire on May 31, 2008. As of December 31, 2006, no amounts were outstanding on these facilities. We believe that cash generated by operations, cash generated by investments and cash available from financing activities will provide sufficient sources of liquidity to meet our anticipated needs over the next 12 to 24 months. We have generated positive operating cash flow for more than 20 consecutive years. In the most recent three years ended December 31, 2006, 2005, and 2004, our operating cash flow was \$171.8 million, \$198.0 million, and \$189.0 million, respectively. The primary factor in our ability to generate positive operating cash flow is underwriting profitability. If we are not able to continue generating positive operating cash flow, we may have to sell investment securities, some of which might be sold at a loss.

OPERATING ACTIVITIES

The following table highlights some of the major sources and uses of cash flow from operating activities:

Sources	Uses
Premiums received	Claims
Loss payments from reinsurers	Ceded premium to reinsurers
Investment income (interest & dividends)	Commissions paid
	Operating expenses
	Interest expense
	Income taxes

Our largest source of cash is from premiums received from our customers, which we receive at the beginning of the coverage period. Our largest cash outflow is for claims that arise when a policyholder incurs an insured loss. Because the payment of claims occurs after the receipt of the premium, often years later, we invest the cash in various investment securities that earn interest and dividends — another source of cash. We use cash to pay commissions to brokers and agents, as well as to pay for ongoing operating expenses such as salaries, rent, taxes, and interest expense. We also utilize reinsurance to manage the risk that we take on our policies. We

cede, or pay out, part of the premiums we receive to our reinsurers, and collect cash back when losses subject to our reinsurance coverage are paid.

The timing of our cash flows from operating activities can vary among periods due to the timing by which payments are made or received. Some of our payments and receipts, including loss settlements and subsequent reinsurance receipts, can be significant, so their timing can influence cash flows from operating activities in any given period. We are subject to the risk of incurring significant losses on catastrophes, both natural (such as earthquakes and hurricanes) and man-made (such as terrorism). If we were to incur such losses, we would have to make significant claims payments in a relatively concentrated period of time.

INVESTING ACTIVITIES

The following table highlights some of the major sources and uses of cash flow from investing activities:

Sources	Uses
Proceeds from bonds sold, called or matured	Purchase of bonds
Proceeds from stocks sold	Purchase of stocks
Proceeds from sale of unconsolidated investee	

We maintain a well-diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of December 31, 2006, our portfolio had a carrying value of \$1.8 billion. Invested assets at December 31, 2006, increased by \$130.5 million, or 7.7 percent, from December 31, 2005. Contributing to this increase was the investment of cash flows from operations.

Our overall investment philosophy is designed to first protect policyholders by maintaining sufficient funds to meet corporate and policyholder obligations, then generate long-term growth in shareholders' equity. Because our existing and projected liabilities are sufficiently funded by the fixed income portfolio, we can improve returns by investing a portion of the surplus (within limits) in an equity portfolio. As of December 31, 2006, 43.8 percent of our shareholders' equity was invested in common stocks, as compared to 46.3 percent at December 31, 2005

and 50.6 percent at December 31, 2004. The 2006 calculation excludes a \$36.7 million investment in a bond mutual fund.

We currently classify 7.8 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 (91.1 percent) or trading (1.1 percent) and are carried at fair value. As of December 31, 2006, we maintained \$1.25 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.

Our fixed income portfolio is managed for safety, focusing on securities of the highest ratings and liquidity. Yield is of secondary importance behind the preservation of capital. The equity portfolio is weighted toward dividend-paying stocks that provide current income as well as long-term growth potential. This philosophy of portfolio diversification, management style, and asset allocation allows us to maximize overall returns within our defined risk tolerances.

Our bond portfolio comprised 74.2 percent of our total 2006 portfolio, versus 78.4 percent of the total at December 31, 2005, and 75.0 percent of the total as of December 31, 2004. As of December 31, 2006, our fixed income portfolio contained 76.9 percent AAA-rated bonds, 10.1 percent AA-rated bonds, 8.6 percent A-rated bonds, and 4.4 percent BBB-rated bonds.

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. As of December 31, 2006, our fixed income portfolio's duration was 4.76 years and remained well diversified. During 2006, the total return on our bond portfolio on a tax-equivalent, mark-to-market basis was 5.25 percent.

In addition, at December 31, 2006, our equity portfolio had a value of \$368.2 million, all of which is classified as available-for-sale and is also a source

of liquidity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. The strategy remains one of value investing, with security selection taking precedence over market timing. A buy-and-hold strategy is used, minimizing both transactional costs and taxes. We maintain a well-diversified group of equity securities. During 2006, the total return on our equity portfolio on a mark-to-market basis was 21.0 percent.

FINANCING ACTIVITIES

In addition to the previously discussed operating and investing activities, we also engage in financing activities to manage our capital structure. The following table highlights some of the major sources and uses of cash flow from financing activities:

Sources	Uses
Proceeds from stock offerings	Shareholder dividends
Proceeds from debt offerings	Debt repayment
Short-term borrowing	Share buy-backs
Shares issued under stock option plans	

Our capital structure is comprised of equity and debt obligations. As of December 31, 2006, our capital structure consisted of \$100.0 million in 10-year maturity senior notes (long-term debt), and \$756.5 million of shareholders' equity. Debt outstanding comprised 11.7 percent of total capital as of December 31, 2006.

Our 123rd consecutive dividend payment was declared in the first quarter of 2007 and will be paid on April 12, 2007, in the amount of \$0.20 per share. Since the inception of cash dividends in 1976, we have increased our annual dividend every year.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authority of Illinois. The maximum dividend distribution 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 its net income for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend distribution that can be paid by RLI Insurance Company during 2007 without prior approval is \$75.7 million. In 2006, a total

of \$59.5 million has been paid in dividends by RLI Insurance Company as follows: asset transfer of Maui Jim valued at \$35.2 million, asset transfer of TBW valued at \$13.4 million, and a cash dividend of \$10.9 million.

In February 2006, we announced a \$100 million common stock repurchase program. Through year end 2006, we repurchased 1,624,009 shares at an average price of \$49.92 per share, which is just over \$81.1 million of the program. We anticipate concluding this repurchase program in 2007.

OUTLOOK FOR 2007

Our insurance marketplace, and in particular the excess and surplus lines segment, is subject to cycles involving alternating periods of price increases (“hard markets”) and price decreases (“soft markets”). Pricing in the overall insurance marketplace has been on the decline for the past several years. We expect this trend to continue, although each of our insurance segments will likely be impacted by varying degrees. We also expect to see some organic growth in 2007 and underwriting income in all three of our insurance segments absent any major catastrophe. Specific details regarding events in our insurance segments follow.

CASUALTY

We expect the price softening seen in 2006 to continue in 2007. We will maintain our profit-focused strategy and look to broaden our production sources and product offerings as a means to holding our market position and potentially growing this segment. Rising profitability and rising levels of capital for the industry will serve to intensify competition for this segment. We look to our ability to exercise underwriting discipline and select quality risks to continue our profitability in 2007.

PROPERTY

The industry took advantage of a quiet Atlantic hurricane season to rebuild capital depleted by hurricane events in 2005. We believe property pricing will soften, but not to pre-Katrina levels. Pricing actions will be tempered by greater rating agency focus on catastrophe claims-paying ability. We expect to continue to see premium growth and favorable loss experience in this segment in 2007. Our marine business should continue to grow moderately, while

we expect losses from our run-off construction book to stabilize.

SURETY

The surety segment, like our other segments, should feel the pressure of a softening marketplace. The steps we have taken over the past several years to address loss experience, coupled with a strong staffing model aided by decision support tools, point to continued profitability in 2007.

INVESTMENTS

Within our investment portfolio, we expect to continue to increase investment income as the balance of our portfolio grows from operating and investing cash flow. Interest rates for bonds with maturities of greater than five years, where a majority of our fixed income portfolio is concentrated, have remained relatively stable in the last couple of years, although they are below the historical average. If interest rates increase, we will be able to invest our cash flow into higher-yielding investments which would improve investment income. However, rising interest rates will depress the fair value of our bond portfolio which will negatively impact comprehensive earnings and book value. Twenty percent of our portfolio is invested in common stocks. We expect the dividend income on these stocks to grow and the value of this portfolio will be dictated by the performance of the general stock market, which is difficult to predict.

ACCOUNTING STANDARDS

SFAS NO. 123 (REVISED 2004),
SHARE-BASED PAYMENT (SFAS 123R)

In December 2004, the Financial Accounting Standards Board (FASB) revised Statement of Financial Accounting Standards (SFAS) No. 123, “Share-Based Payment,” (SFAS 123R) which required companies to expense the estimated fair value of employee stock options and similar awards, for all options vesting, granted, or modified after the effective date of this revised statement. The accounting provisions of SFAS 123R were to become effective for interim periods beginning after June 15, 2005. In April 2005, the Securities and Exchange Commission (SEC) adopted a final rule amending Rule 4-01(a) of Regulation S-X regarding the compliance date for SFAS 123R. The effect of this ruling was to

delay the effective date of SFAS 123R to the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005. As a result, the accounting provisions of SFAS 123R became effective for our financial statements beginning January 1, 2006.

SFAS 123R is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), and supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), and its related implementation guidance. On January 1, 2006, we adopted the provisions of SFAS 123R using the modified prospective method. SFAS 123R requires entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). Prior to the adoption of SFAS 123R, we followed the intrinsic value method in accordance with APB 25 to account for our employee stock options and recognized no compensation expense for the stock option grants.

SFAS NO. 154, ACCOUNTING CHANGES AND ERROR CORRECTIONS (SFAS 154)

We adopted SFAS 154 on January 1, 2006. SFAS 154 replaces APB 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS 154 requires retrospective application to prior periods' financial statements for changes in accounting principle, unless determination of either the period specific effects or the cumulative effect of the change is impracticable or otherwise promulgated. We had no accounting changes or error corrections affected by the new standard.

SFAS NO. 155, ACCOUNTING FOR CERTAIN HYBRID FINANCIAL INSTRUMENTS — AN AMENDMENT OF FASB STATEMENTS NO. 133 AND 140 (SFAS 155)

In February 2006, the FASB issued SFAS 155, "Accounting for Certain Hybrid Financial Instruments." SFAS 155 amends FASB Statement No. 133 and FASB Statement No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the

accounting for these instruments. Specifically, SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Companies are required to adopt the provisions of SFAS 155, as applicable, beginning in fiscal year 2007. We do not believe the adoption of SFAS 155 will have a material impact on our financial position or results of operations.

FASB INTERPRETATION NO. 48, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, (FIN 48)

In July 2006, the FASB issued FIN 48, which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 requires an entity to recognize the benefit of tax positions only when it is more likely than not, based on the position's technical merits, that the position would be sustained upon examination by the respective taxing authorities. The tax benefit is measured as the largest benefit that is more than 50 percent likely of being realized upon final settlement with the respective taxing authorities. FIN 48 is effective for fiscal years beginning after December 15, 2006. FIN 48 is not expected to have a material effect on our financial position or results of operations.

SFAS NO. 157, "FAIR VALUE MEASUREMENTS" (SFAS 157)

In September 2006, the FASB issued SFAS No. 157. SFAS 157 defines fair value and establishes a framework for measuring fair value in GAAP. The pronouncement describes fair value as being based on a hypothetical transaction to sell an asset or transfer a liability at a specific measurement date, as considered from the perspective of a market participant who holds the asset or owes the liability. In addition, fair value should be viewed as a market-based measurement, not an entity-specific measurement. Therefore, fair value should be determined based on the assumptions that market participants would use in pricing an asset or liability,

including all risks associated with that asset or liability. SFAS 157 becomes effective for fiscal years beginning after November 15, 2007. We are currently reviewing the guidance provided in this standard to determine the impact on our financial position and results of operations.

SFAS NO. 158, "EMPLOYERS' ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POST RETIREMENT PLANS—AN AMENDMENT OF FASB STATEMENTS NO 87, 88, 106 AND 132(R)" (SFAS 158)

In September 2006, the FASB issued SFAS No. 158. SFAS 158 improves reporting of obligations for pensions and other post-retirement benefits by recognizing the over-funded or under-funded status of plans as an asset or liability. The pronouncement does not change how plan assets and benefit obligations are measured under SFAS 87 and SFAS 106 nor does it change the approach for measuring annual benefit cost reported in earnings. Rather, it eliminates the provisions that permit plan assets and obligations to be measured as of a date not more than three months prior to the balance sheet date, instead requiring measurement as of the reporting date. In addition, the pronouncement requires previously unrecognized items, such as actuarial gains and unrecognized prior service costs or credits to be recognized on the balance sheet as a component of other comprehensive income (loss). As discussed in note 8, our defined benefit pension plan was terminated in 2006. The implementation of SFAS 158 had no impact on our financial position or results of operations.

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 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.

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 prenotification 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 pre-acquisition notification in applicable states that have adopted pre-acquisition notification provisions. Obtaining these approvals could result in material delay of, or deter, any such transaction.

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.

Under state insurance laws, our insurance company subsidiaries cannot treat reinsurance ceded to an unlicensed or non-accredited reinsurer as an asset or as a deduction from its liabilities in their statutory financial statements, except to the extent that the reinsurer has provided collateral security in an approved form, such as a letter of credit. As of December 31, 2006, \$1.6 million of our reinsurance recoverables were due from unlicensed or non-accredited reinsurers that had not provided us with approved collateral.

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. For example, the state

of Florida passed legislation in early 2007 seeking to make residential homeowners' insurance in Florida more accessible and affordable by imposing regulatory changes and restrictions on many aspects of the insurance market in that state. The near-term impact to us is not expected to be material since we currently write a relatively small amount of residential homeowners' insurance in that state. However, such legislation is new, and thus its full impact, as well as the reaction of any other coastal state, is not yet certain. We will continue to carefully monitor the legislative and regulatory activity in this area.

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 between 1 percent and 2 percent 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 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.

BROKER CONTINGENT COMMISSIONS

In 2004, the New York attorney general began an investigation into insurance broker and insurance company activities connected with contingent commission arrangements. The investigation led to lawsuits, both private suits and suits by attorneys general, and prompted other attorneys general and state insurance departments to conduct further investigations. We have responded to all inquiries from state attorneys general and insurance departments, and have not been subject to any regulatory actions or paid any fees or fines as a result. We also conducted an internal investigation of our contingent commission arrangements and related underwriting practices and found no improper actions. We have also established a corporate policy regarding the proper use and

authorization of contingent commission agreements. The National Association of Insurance Commissioners (NAIC) has created a model act on these agreements for agents and brokers, and statutes have been proposed or enacted in several states. We continue to closely monitor all legislative developments.

TERRORISM EXCLUSION REGULATORY ACTIVITY

After the events of September 11, 2001, the 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 set to expire on December 31, 2005, but the law has been extended until December 31, 2007. 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 terrorism is partially reimbursed by the United States under a formula whereby the government pays 90 percent in 2006 and 85 percent in 2007 of covered terrorism losses exceeding a prescribed deductible to the insurance company providing the coverage. The deductible is calculated as 17.5 percent in 2006 and 20 percent in 2007 of gross earned premium net of a few excludable lines. 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 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. Congress

is currently considering an extension of TRIA, although such action is not certain.

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.

The annual certification of our CEO with respect to compliance with the New York Stock Exchange corporate governance listing standards has been submitted to the New York Stock Exchange and the annual certifications of our CEO and CFO required by the Sarbanes-Oxley Act of 2002 with respect to the our 2006 fiscal year have been filed with the SEC as an exhibit to our annual report on Form 10-K for 2006.

ASBESTOS LITIGATION REFORM

Congress has considered, but not yet enacted, asbestos litigation reform legislation. Alternatives range from a proposal requiring manufacturers and insurers to fund liabilities for asbestos exposure to provide for a remedy for all asbestos-related claims, to a proposal requiring victims to document their medical condition before suing for damages. We continue to monitor our expected exposure and do not perceive a significant risk.

FEDERAL REGULATION OF INSURANCE

In 2006, two separate bills were introduced in Congress that would provide significant federal regulation in the insurance industry. One bill provides for an optional federal charter, and the other seeks to streamline and reduce the state regulatory burden for non-admitted/surplus lines of insurance. This proposed legislation would have a significant impact on the insurance industry, and we continue to monitor all proposals.

Also, in early 2007, bills were introduced in Congress to repeal the antitrust exemption for the insurance industry in the McCarran-Ferguson Act. We will monitor this proposed legislation, but we cannot predict if such bills will become law or the impact of such legislation on the company or the industry.

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): 2006 summary annual report; 2006 financial report; 2007 proxy statement; annual report on Form 10-K for 2006; and charters of the executive resources, audit, finance and investment, strategy, and nominating/corporate governance committees of the board of directors. Printed copies of these documents will be made available upon request without charge to any shareholder.

FORWARD LOOKING STATEMENTS

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,” 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. 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.