

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Description of business: We underwrite selected property and casualty insurance coverages.

We conduct operations principally through three insurance companies. RLI Insurance Company (RLI), our principal subsidiary, writes multiple lines insurance on an admitted basis in all 50 states, the District of Columbia, and Puerto Rico. Mt. Hawley Insurance Company, a subsidiary of RLI Insurance Company, writes surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, and Guam. RLI Indemnity Company (RIC), a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines insurance on an admitted basis in 49 states and the District of Columbia.

B. Principles of consolidation and basis of presentation: The accompanying consolidated financial statements were prepared in conformity with GAAP (accounting principles generally accepted in the United States of America), which differ in some respects from those followed in reports to insurance regulatory authorities. The consolidated financial statements include the accounts of our holding company and our subsidiaries. All significant intercompany balances and transactions have been eliminated. Certain reclassifications were made to the prior years' financial statements to conform with the classifications used in 2006.

C. Investments: In compliance with Statement of Financial Accounting Standards (SFAS) 115, "Accounting for Certain Investments in Debt and Equity Securities," we classify our investments in all debt securities and those equity securities with readily determinable fair values into one of three categories: available-for-sale, held-to-maturity, or trading.

AVAILABLE-FOR-SALE SECURITIES

Debt and equity securities not included as held-to-maturity or trading are classified as available-for-sale and reported at fair value, based upon quoted market prices. Unrealized gains and losses on these securities are excluded from net earnings but are recorded as a separate component of comprehensive earnings and shareholders' equity, net of deferred income taxes. All of our equity securities and approximately 91 percent of debt securities are classified as available-for-sale.

HELD-TO-MATURITY SECURITIES

Debt securities that we have the positive intent and ability to hold to maturity are classified as held-to-maturity and carried at amortized cost. Except for declines that are other than temporary, changes in the fair value of these securities are not reflected in the financial statements. We have classified approximately 8 percent of our debt securities portfolio as held-to-maturity.

TRADING SECURITIES

Debt and equity securities purchased for short-term resale are classified as trading securities. These securities are reported at fair value with unrealized gains and losses included in earnings. We have classified approximately 1 percent of our debt securities portfolio as trading.

For the years ended December 31, 2006, 2005, and 2004, no securities were transferred from held-to-maturity to available-for-sale or trading.

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

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 continuously monitor the values of our investments in fixed maturities and equity securities. If this review suggests that a decline in fair value is other than temporary, our carrying value in the investment is reduced to its fair value through an adjustment to earnings. Realized gains and losses on disposition of investments are based on specific identification of the investments sold on the trade date.

Interest on fixed maturities and short-term investments is credited to earnings as it accrues. Premiums and discounts are amortized or accreted over the lives of the related fixed maturities. Dividends on equity securities are credited to earnings on the ex-dividend date.

D. Reinsurance: Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not relieve us of our legal liability to our policyholders.

We continuously monitor the financial condition of our reinsurers. Our policy is to periodically charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. We believe that current reserve levels for uncollectible reinsurance are sufficient to cover our exposures.

E. Unpaid losses and settlement expenses: The liability for unpaid losses and settlement expenses represents estimates of amounts needed to pay reported and unreported claims and related expenses. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social, and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. Due to the inherent uncertainty in estimating reserves for losses and settlement expenses, there can be no assurance that the ultimate liability will not exceed recorded amounts. If actual liabilities do exceed recorded amounts, there will be an adverse effect. Furthermore, we may determine that recorded reserves are more than adequate to cover expected losses, as happened during 2005 and 2006, when favorable experience on casualty business led us to reduce our reserves. Based on the current assumptions used in estimating reserves, we believe that our overall reserve levels at December 31, 2006, make a reasonable provision to meet our future obligations. See note 6 for a further discussion of unpaid losses and settlement expenses.

F. Insurance revenue recognition: Insurance premiums are recognized ratably over the term of the contracts, net of ceded reinsurance. Unearned premiums are calculated on a monthly pro rata basis.

G. 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.

H. Property and equipment: Property and equipment are presented at cost less accumulated depreciation and are depreciated on a straight-line basis for financial statement purposes over periods ranging from three to 10 years for equipment and up to 30 years for buildings and improvements.

I. Intangible assets: In accordance with SFAS 142, "Goodwill and Other Intangible Assets," the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or when there is reason to suspect that their values may have been diminished or impaired. Goodwill and indefinite-lived intangible assets, which relate to our surety segment, are listed separately on the balance sheet and totaled \$26.2 million at December 31, 2006 and 2005. Impairment testing was performed during 2006, pursuant to the requirements of SFAS 142. Based upon this review, these assets are not impaired.

Intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite-lived intangible assets that continue to be amortized under SFAS 142 relate to our purchase of customer-related and marketing-related intangibles. These intangibles have useful lives ranging from five to 10 years. Amortization of intangible assets was \$0.4 million for 2006, compared to \$0.5 million for 2005 and \$1.3 million in 2004. Amortization expense in 2004 includes \$0.7 million of additional expense recorded, pursuant to our review of the recoverability of the definite-lived intangible asset relating to contract surety. Definite-lived intangibles are subject to review for impairment pursuant to the requirements of SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 requires, among other things, that we review our long-lived assets and certain related intangibles

for impairment whenever changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. During 2004, we reviewed the recoverability of the definite-lived intangible asset relating to contract surety. In accordance with SFAS 144, this asset was tested for impairment by comparing the asset's projected undiscounted cash flows to its carrying value. Results of these tests indicated the asset was not recoverable. We recorded \$0.7 million of amortization expense. Subsequent to this adjustment, this asset had a carrying value of \$0.

Amortization expense on intangible assets is expected to be \$0.1 million in 2007. In 2007, these assets will be fully amortized. At December 31, 2006, net intangible assets totaled \$0.1 million, net of \$5.6 million of accumulated amortization, and are included in other assets. At December 31, 2005, net intangible assets totaled \$0.5 million, net of \$5.2 million of accumulated amortization.

J. Investment in unconsolidated investees: We maintain a 40 percent interest in the earnings of Maui Jim, Inc. (Maui Jim), primarily a manufacturer of high-quality polarized sunglasses, which is accounted for by the equity method. We also maintain a similar minority representation on their board of directors, held by our chairman, president, and CFO. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim, Inc. Our investment in Maui Jim was \$36.7 million in 2006 and \$44.3 million in 2005. In 2006, we recorded \$8.8 million in investee earnings compared to \$8.4 million in 2005 and \$5.0 million in 2004. Maui Jim recorded net income of \$22.1 million in 2006, \$20.1 million in 2005 and \$10.9 million in 2004. Additional summarized financial information for Maui Jim for 2006 and 2005 is outlined in the following table:

(in millions)	2006	2005
Current assets	\$ 77.0	\$ 80.8
Total assets	113.9	114.6
Current liabilities	45.7	22.7
Total liabilities	46.7	28.7
Total equity	67.2	85.9

Approximately \$23.8 million of undistributed earnings from Maui Jim are included in our retained earnings as of December 31, 2006.

In January 2007, the board of directors of Maui Jim declared a dividend that will be payable in the first

quarter of 2007. Our share of the cash dividend will be \$5.9 million. The tax benefit associated with this dividend is discussed in note 7. We also received a dividend of \$16.5 million from Maui Jim in 2006.

Prior to December 2006, we also maintained a 21 percent interest in the earnings of Taylor, Bean & Whitaker Mortgage Corp. (TBW), a private mortgage origination company which was accounted for by the equity method. In December 2006, we sold our interest in the company for \$32.5 million to TBW's chairman who owned the majority of the outstanding shares prior to the sale. We realized a \$16.2 million pretax gain on the sale of equity. Our ownership commenced in October 2004 when we exercised warrants that were acquired in 1999. Our investment in TBW, prior to the sale, was \$16.3 million in 2006, compared to \$10.0 million in 2005 and \$7.5 million in 2004. In 2006, we recorded \$6.3 million in investee earnings, compared to \$2.5 million in 2005.

In December 2006, we became a 17% participant in a loan syndicate which provided TBW's majority shareholder with short-term financing. Our share of the loan totaled \$5.0 million. The loan is collateralized by TBW shares and our portion contains the same market terms and conditions as those of the lead and other syndicate members. We also have a separate note receivable from TBW totaling \$4.5 million at December 31, 2006, which originated in 1999 as an operating loan.

We perform impairment reviews of our investments in unconsolidated investees. Based upon these reviews, these assets were not impaired.

K. Income taxes: We file a consolidated income tax return. Income taxes are accounted for using the asset and liability method under which deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities, operating losses, and tax credit carry forwards. The effect on deferred taxes for a change in tax rates is recognized in income in the period that includes the enactment date.

L. Earnings per share: Pursuant to disclosure requirements contained in SFAS 128, "Earnings per Share," the following represents a reconciliation of the numerator and denominator of the basic and diluted

earnings per share (EPS) computations contained in the financial statements.

(in thousands, except per share data)	Income (Numerator)	Shares (Denominator)	Per Share Amount
For the year ended December 31, 2006			
Basic EPS			
Income available to common shareholders	\$134,639	24,918	\$5.40
Stock options	—	653	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$134,639	25,571	\$5.27
For the year ended December 31, 2005			
Basic EPS			
Income available to common shareholders	\$107,134	25,459	\$4.21
Stock options	—	865	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$107,134	26,324	\$4.07
For the year ended December 31, 2004			
Basic EPS			
Income available to common shareholders	\$ 73,036	25,223	\$2.90
Stock options	—	870	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$ 73,036	26,093	2.80

M. Comprehensive earnings: The difference between our net earnings and our comprehensive earnings is that comprehensive earnings include unrealized gains/losses net of tax, whereas net earnings does not include such amounts, and such amounts are instead directly credited or charged against shareholders' equity. In reporting the components of comprehensive earnings on a net basis in the income statement, we have used a 35 percent tax rate. Other comprehensive income (loss), as shown, is net of tax expense (benefit) of \$12.0 million, \$(12.5) million, and \$4.5 million, respectively, for 2006, 2005, and 2004.

N. Fair value disclosures: The following methods were used to estimate the fair value of each class of financial instruments for which it was practicable to estimate that value. Fixed maturities and equity securities are valued using quoted market prices, if

available. If a quoted market price is not available, fair value is estimated using independent pricing services or quoted market prices of similar securities. Fair value disclosures for investments are included in note 2. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, accounts payable, and short-term debt, their carrying amounts are reasonable estimates of fair value.

O. Stock based compensation: 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. 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.

On November 10, 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. SFAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards." The alternative transition method includes

simplified methods to establish the beginning balance of the additional paid-in capital pool (“APIC pool”) related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee share-based compensation awards that are outstanding upon adoption of SFAS 123(R). We have elected to adopt the alternative transition method provided in this FASB Staff Position for calculating the tax effects of share-based compensation pursuant to SFAS 123(R).

See note 8 for further discussion and related disclosures regarding stock options.

P. Risks and uncertainties: Certain risks and uncertainties are inherent to our day-to-day operations and to the process of preparing our financial statements. The more significant risks and uncertainties, as well as our methods for mitigating, quantifying and minimizing such, are presented below and throughout the notes to the consolidated financial statements.

CATASTROPHE EXPOSURES

Our insurance coverages include exposure to catastrophic events. 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. Using computer-assisted modeling techniques, we monitor and manage our exposure to catastrophic events. Additionally, we further limit our risk to such catastrophes through the purchase of reinsurance. In 2006, our property underwriting was supported by \$450 million in traditional catastrophe reinsurance protection, subject to certain retentions by us. At January 1, 2007, we increased our reinsured limit of catastrophe coverage for earthquake exposures by \$50 million, thereby bringing our total reinsurance protection to \$500 million, subject to certain retentions by us. We actively restructure our catastrophe program in order to maximize limits and minimize costs.

ENVIRONMENTAL EXPOSURES

We are subject to environmental claims and exposures through our commercial umbrella, general

liability, and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, we have sought to mitigate or control the extent of this exposure through the following methods: 1) our policies include pollution exclusions that have been continually updated to further strengthen the exclusions, 2) our policies primarily cover moderate hazard risks, and 3) we began writing this business after the insurance industry became aware of the potential pollution liability exposure.

We have made loss and settlement expense payments on environmental liability claims and have loss and settlement expense reserves for others. We include this historical environmental loss experience with the remaining loss experience in the applicable line of business to project ultimate incurred losses and settlement expenses as well as related incurred but not reported (IBNR) loss and settlement expense reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, we have used this experience to record loss and settlement expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 6.

REINSURANCE

Reinsurance does not discharge us from our primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, we would be liable. We continuously monitor the financial condition of prospective and existing reinsurers. As a result, we currently purchase reinsurance from a limited number of financially strong reinsurers. We provide a reserve for reinsurance balances deemed uncollectible. See further discussion of reinsurance exposures in note 5.

FINANCIAL STATEMENTS

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. See note 10 for a discussion of a significant policy-related contingency. Actual results could differ from those estimates.

The most significant of these amounts is the liability for unpaid losses and settlement expenses. We continually update our estimates as additional data becomes available and adjusts the financial statements as deemed necessary. Other estimates such as investment valuation, the collectibility of reinsurance balances, recoverability of deferred tax assets, and deferred policy acquisition costs are regularly monitored, evaluated, and adjusted. Although recorded estimates are supported by actuarial computations and other supportive data, the estimates are ultimately based on our expectations of future events.

EXTERNAL FACTORS

Our insurance subsidiaries are highly regulated by the states in which they are incorporated and by the states in which they do business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments and regulate rates insurers may charge for various coverages. We are also subject to insolvency and guarantee fund assessments for various programs designed to ensure policyholder indemnification. We generally accrue an assessment during the period in which it becomes probable that a liability has been incurred from an insolvency and the amount of the related assessment can be reasonably estimated.

The National Association of Insurance Commissioners (NAIC) has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. We regularly monitor our subsidiaries' internal capital requirements and the NAIC's RBC developments. As of December 31, 2006, we have determined that our capital levels are well in excess of the minimum capital requirements for all RBC action levels and that our capital levels are sufficient to support the level of risk inherent in our operations.

In addition, ratings are a critical factor in establishing the competitive position of insurance companies. Our insurance companies are rated by A.M. Best, Standard & Poor's, and Moody's. Their ratings reflect their opinions of an insurance company's and an insurance holding company's financial strength, operating performance, strategic position, and ability to meet its obligations to policyholders.

2. INVESTMENTS

A summary of net investment income is as follows:

Net Investment Income (in thousands)	2006	2005	2004
Interest on fixed maturities	\$64,486	\$56,427	\$49,657
Dividends on equity securities	10,402	9,466	8,919
Appreciation in private equity warrants	—	—	110
Interest on short-term investments	2,125	1,316	621
Gross investment income	77,013	67,209	59,307
Less investment expenses	(5,688)	(5,568)	(5,220)
Net investment income	\$71,325	\$61,641	\$54,087

Pretax net realized investment gains (losses) and net changes in unrealized gains (losses) on investments for the years ended December 31 are summarized as follows:

Realized/unrealized gains (in thousands)	2006	2005	2004
Net realized investment gains (losses)			
Fixed maturities			
Available-for-sale	\$ (7,351)	\$ 573	\$ 335
Held-to-maturity	92	18	126
Trading	(53)	(32)	(154)
Equity securities	38,578	15,887	12,824
Other	(221)	(92)	234
	31,045	16,354	13,365
Net changes in unrealized gains (losses) on investments			
Fixed maturities			
Available-for-sale	2,323	(24,070)	(1,725)
Held-to-maturity	(2,030)	(5,055)	(4,841)
Equity securities	32,072	(11,718)	14,925
	32,365	(40,843)	8,359
Net realized investment gains and changes in unrealized gains (losses) on investments	\$63,410	\$(24,489)	\$21,724

Following is a summary of the disposition of fixed maturities and equities for the years ended December 31, with separate presentations for sales and calls/maturities:

(in thousands)	Proceeds From Sales	Gross Realized Gains	Realized Losses	Net Realized Gain(Loss)
Sales				
2006 – Available-for-sale	\$231,385	\$666	\$(8,076)	\$ (7,410)
Trading	4,950	17	(70)	(53)
Equities	179,134	41,097	(2,519)	38,578
2005 – Available-for-sale	\$149,724	\$ 2,629	\$(2,319)	\$ 310
Trading	1,359	4	(34)	(30)
Equities	72,374	18,791	(2,904)	15,887
2004 – Available-for-sale	\$108,088	\$ 300	\$(252)	\$ 48
Trading	2,645	126	(3)	123
Equities	39,638	13,677	(853)	12,824
Calls/Maturities				
2006 – Available-for-sale	\$117,204	\$ 59	\$ -	\$ 59
Held-to-maturity	28,215	92	-	92
Trading	1,083	-	-	-
2005 – Available-for-sale	\$ 55,578	\$ 263	\$ -	\$ 263
Held-to-maturity	25,363	19	(1)	18
Trading	942	-	(2)	(2)
2004 – Available-for-sale	\$ 71,814	\$ 303	\$(16)	\$ 287
Held-to-maturity	24,080	126	-	126
Trading	524	-	-	-

The following is a schedule of amortized costs and estimated fair values of investments in fixed maturities and equity securities as of December 31, 2006 and 2005:

(in thousands)	Amortized Cost	Estimated Fair Value	Gross Unrealized Gains	Losses
2006				
Available-for-sale				
U.S. government	\$ 8,792	\$ 8,541	\$ 12	\$(263)
U.S. agencies	465,629	461,831	588	(4,386)
Mtge/ABS/CMO*	109,538	109,272	824	(1,090)
Corporate	237,905	235,291	1,645	(4,259)
States, political subdivisions & revenues	418,156	419,636	3,338	(1,858)
Fixed maturities	1,240,020	1,234,571	6,407	(11,856)
Equity securities	201,443	368,195	167,279	(527)
Total available-for-sale	\$1,441,463	\$1,602,766	\$173,686	\$(12,383)
Held-to-maturity				
U.S. government	\$ 6,291	\$ 6,309	\$ 21	\$(3)
U.S. agencies	18,850	19,415	625	(60)
States, political subdivisions & revenues	81,169	83,006	1,837	-
Total held-to-maturity	\$ 106,310	\$ 108,730	\$ 2,483	\$(63)
Trading				
U.S. government	\$ 2,438	\$ 2,399	\$ 2	\$(41)
U.S. agencies	4,679	4,630	5	(54)
Mtge/ABS/CMO*	3,015	2,979	3	(39)
Corporate	4,893	4,848	18	(63)
States, political subdivisions & revenues	100	104	4	-
Total trading	15,125	14,960	32	(197)
Total	\$1,562,898	\$1,726,456	\$176,201	\$(12,643)

(in thousands)	Amortized Cost	Estimated Fair Value	Gross Gains	Unrealized Losses
2005				
Available-for-sale				
U.S. government	\$ 9,492	\$ 9,324	\$ 31	\$ (199)
U.S. agencies	440,237	435,561	596	(5,272)
Mtge/ABS/CMO*	107,638	106,298	446	(1,786)
Corporate	210,748	208,760	2,634	(4,622)
States, political subdivisions & revenues	421,293	421,693	3,414	(3,014)
Fixed maturities	1,189,408	1,181,636	7,121	(14,893)
Equity securities	186,417	321,096	135,493	(814)
Total available-for-sale	\$1,375,825	\$1,502,732	\$142,614	\$(15,707)
Held-to-maturity				
U.S. government	\$ 10,104	\$ 10,224	\$ 120	\$ -
U.S. agencies	23,770	24,800	1,078	(48)
States, political subdivisions & revenues	100,577	103,878	3,301	-
Total held-to-maturity	\$ 134,451	\$ 138,902	\$ 4,499	\$(48)
Trading				
U.S. government	\$3,523	\$3,481	\$ 10	\$(52)
U.S. agencies	3,370	3,345	24	(49)
Mtge/ABS/CMO*	3,441	3,391	-	(50)
Corporate	5,031	4,989	17	(59)
States, political subdivisions & revenues	100	106	6	-
Total trading	15,465	15,312	57	(210)
Total	\$1,525,741	\$1,656,946	\$147,170	\$(15,965)

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

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
Available-for-sale		
Due in one year or less	\$ 3,662	\$ 3,664
Due after one year through five years	251,561	250,469
Due after five years through 10 years	605,338	604,189
Due after 10 years	379,459	376,249
	\$1,240,020	\$1,234,571
Held-to-maturity		
Due in one year or less	\$15,337	\$15,441
Due after one year through five years	61,207	62,566
Due after five years through 10 years	29,766	30,723
Due after 10 years	-	-
	\$ 106,310	\$ 108,730
Trading		
Due in one year or less	\$ -	\$ -
Due after one year through five years	5,166	5,119
Due after five years through 10 years	5,705	5,620
Due after 10 years	4,254	4,221
	\$ 15,125	\$ 14,960
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
	\$1,361,455	\$1,358,261

Expected maturities may differ from contractual maturities due to call provisions on some existing securities and prepayment features on mortgage-backed, asset-backed, and collateralized mortgage obligations. At December 31, 2006, the net unrealized appreciation of available-for-sale fixed maturities and equity securities totaled \$161.3 million. At December 31, 2005, the net unrealized appreciation of available-for-sale fixed maturities and equity securities totaled \$126.9 million.

The following tables are also used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of December 31, 2006 and December 31, 2005, respectively. These tables segregate the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of

investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position.

Investment Positions with Unrealized Losses Segmented by Type and Period of Continuous Unrealized Loss at December 31, 2006			
(in thousands)	0-12 Mos.	>12 Mos.	Total
U.S. Government			
Fair value	\$ 1,850	\$ 8,994	\$ 10,844
Cost or amortized cost	1,856	9,296	11,152
Unrealized loss	(6)	(302)	(308)
U.S. Agency			
Fair value	\$113,858	\$147,103	\$260,961
Cost or amortized cost	114,245	148,987	263,232
Unrealized loss	(387)	(1,884)	(2,271)
Mtge/ABS/CMO*			
Fair value	\$ 69,800	\$129,598	\$199,398
Cost or amortized cost	70,108	132,874	202,982
Unrealized loss	(308)	(3,276)	(3,584)
Corporate debt securities			
Fair value	\$ 59,079	\$ 86,074	\$145,153
Cost or amortized cost	59,629	89,620	149,249
Unrealized loss	(550)	(3,546)	(4,096)
States, political subdivisions, revenues & debt securities			
Fair value	\$117,351	\$ 99,216	\$216,567
Cost or amortized cost	117,765	100,659	218,424
Unrealized loss	(414)	(1,443)	(1,857)
Subtotal, debt securities			
Fair value	\$361,938	\$470,985	\$832,923
Cost or amortized cost	363,603	481,436	845,039
Unrealized loss	(1,665)	(10,451)	(12,116)
Common stock			
Fair value	\$ 12,519	\$ -	\$ 12,519
Cost or amortized cost	13,046	-	13,046
Unrealized loss	(527)	-	(527)
Total			
Fair value	\$374,457	\$470,985	\$845,442
Cost or amortized cost	376,649	481,436	858,085
Unrealized loss	(2,192)	(10,451)	(12,643)

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

Investment Positions with Unrealized Losses Segmented by Type and Period of Continuous Unrealized Loss at December 31, 2005			
(in thousands)	0-12 Mos.	>12 Mos.	Total
U.S. Government			
Fair value	\$ 10,062	\$ -	\$ 10,062
Cost or amortized cost	10,313	-	10,313
Unrealized loss	(251)	-	(251)
U.S. Agency			
Fair value	\$338,930	\$ 35,118	\$374,048
Cost or amortized cost	343,141	36,278	379,419
Unrealized loss	(4,211)	(1,160)	(5,371)
Mtge/ABS/CMO*			
Fair value	\$ 84,283	\$ 2,852	\$ 87,135
Cost or amortized cost	86,104	2,866	88,970
Unrealized loss	(1,821)	(14)	(1,835)
Corporate debt securities			
Fair value	\$103,121	\$ 42,269	\$145,390
Cost or amortized cost	105,798	44,271	150,069
Unrealized loss	(2,677)	(2,002)	(4,679)
States, political subdivisions, revenues & debt securities			
Fair value	\$210,089	\$ 17,904	\$227,993
Cost or amortized cost	212,673	18,335	231,008
Unrealized loss	(2,584)	(431)	(3,015)
Subtotal, debt securities			
Fair value	\$746,485	\$ 98,143	\$844,628
Cost or amortized cost	758,029	101,750	859,779
Unrealized loss	(11,544)	(3,607)	(15,151)
Common stock			
Fair value	\$ 13,019	\$ -	\$ 13,019
Cost or amortized cost	13,833	-	13,833
Unrealized loss	(814)	-	(814)
Total			
Fair value	\$759,504	\$ 98,143	\$857,647
Cost or amortized cost	771,862	101,750	873,612
Unrealized loss	(12,358)	(3,607)	(15,965)

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

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 securities 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 primarily be attributed to an increase in intermediate and long-term interest rates since the purchase of many of these fixed income securities. 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.

At December 31, 2006, we were party to a securities lending program whereby fixed-income securities are loaned to third parties, primarily major brokerage firms. At December 31, 2006, fixed maturities with a fair value of \$46.8 million were loaned. Agreements with custodian banks facilitating such lending generally require 102 percent of the value of the loaned securities to be separately maintained as collateral for each loan. Pursuant to SFAS 140, an invested asset and a corresponding liability have been recognized for the cash collateral amount. To further minimize the credit risks related to this lending program, we monitor the financial condition of other parties to these agreements.

As required by law, certain fixed maturities and short-term investments amounting to \$18.8 million at December 31, 2006, were on deposit with either

regulatory authorities or banks. Additionally, we have certain fixed maturities held in trust amounting to \$15.0 million at December 31, 2006. These funds cover net premiums, losses, and expenses related to a property and casualty insurance program.

3. POLICY ACQUISITION COSTS

Policy acquisition costs deferred and amortized to income for the years ended December 31 are summarized as follows:

(in thousands)	2006	2005	2004
Deferred policy acquisition costs, beginning of year	\$ 69,477	\$ 67,146	\$ 63,737
Deferred:			
Direct commissions	126,270	120,996	120,323
Premium taxes	6,483	7,572	8,460
Other direct underwriting expenses	54,946	50,312	43,154
Ceding commissions	(41,520)	(44,126)	(36,881)
Net deferred	146,179	134,754	135,056
Amortized	141,839	132,423	131,647
Deferred policy acquisition costs, end of year	\$ 73,817	\$ 69,477	\$ 67,146
Policy acquisition costs:			
Amortized to expense	141,839	132,423	131,647
Period costs:			
Ceding commission - contingent	(3,049)	(5,698)	(5,368)
Other	6,986	9,333	8,316
Total policy acquisition costs	\$145,776	\$136,058	\$134,595

4. DEBT

As of December 31, 2006, outstanding debt balances totaled \$100.0 million, consisting only of long-term senior notes. These notes are rated Baa2 by Moody's and BBB+ by Standard & Poor's.

On December 12, 2003, we completed a public debt offering, issuing \$100.0 million in senior notes maturing January 15, 2014, 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. The amount of the discount is being charged to income over the life of the debt on an effective-yield basis. Of the proceeds, capital contributions were made in 2003 and 2004 to our insurance subsidiaries to increase their statutory surplus in the amounts of \$50.0 million and \$15.0 million, respectively. The

balance of the proceeds was used by the holding company to fund investment and operating activities.

We paid off all short-term debt previously held through reverse repurchase transactions at the insurance subsidiaries, leaving us with no short-term debt as of December 31, 2006, compared to December 31, 2005, short-term debt balances of \$15.5 million. The pool of securities underlying the reverse repurchase transactions consists of U.S. government and agency securities. With no outstanding reverse repurchase transactions at December 31, 2006, there was no carrying value of securities associated with such transactions, compared with a December 31, 2005, carrying value of \$15.2 million. The use and repayment of such agreements remains an investment decision, based on whether the allocation of available cash flow to purchase debt securities generates a greater amount of investment income than would be paid in interest expense.

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 incurred interest expense on debt at the following average interest rates for 2006, 2005, and 2004:

	2006	2005	2004
Line of credit	-	-	-
Reverse repurchase agreements	4.97%	3.00%	1.62%
Total short-term debt	5.34%	3.17%	1.79%
Senior notes	6.02%	6.02%	6.02%
Total debt	5.95%	5.27%	4.66%

Interest paid on outstanding debt for 2006, 2005, and 2004 amounted to \$6.6 million, \$7.2 million, and \$4.0 million respectively.

5. REINSURANCE

In the ordinary course of business, the insurance subsidiaries assume and cede premiums with other insurance companies. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk (known as facultative reinsurance).

In addition, there are quota share, excess of loss and catastrophe reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. The arrangements allow us to pursue greater diversification of business and serve to limit the maximum net loss on catastrophes and large risks.

Through the purchase of reinsurance, we generally limit our net loss on any individual risk to a maximum of \$2.0 million, although retentions can range from \$0.5 million to \$7.0 million. Additionally, through extensive use of computer-assisted modeling techniques, we monitor the concentration of risks exposed to catastrophic events.

Premiums written and earned along with losses and settlement expenses incurred for the years ended December 31 are summarized as follows:

(in thousands)	2006	2005	2004
Written			
Direct	\$ 794,093	\$ 748,852	\$ 745,227
Reinsurance assumed	4,920	7,160	7,361
Reinsurance ceded	(247,477)	(261,447)	(241,376)
Net	\$ 551,536	\$ 494,565	\$ 511,212
Earned			
Direct	\$ 788,904	\$ 731,483	\$ 744,596
Reinsurance assumed	5,982	7,629	8,305
Reinsurance ceded	(264,548)	(247,805)	(241,553)
Net	\$ 530,338	\$ 491,307	\$ 511,348
Losses and settlement expenses incurred			
Direct	\$ 381,661	\$ 506,434	\$ 486,978
Reinsurance assumed	8,956	7,277	4,273
Reinsurance ceded	(133,728)	(262,541)	(185,120)
Net	\$ 256,889	\$ 251,170	\$ 306,131

At December 31, 2006, we had prepaid reinsurance premiums and reinsurance recoverables on paid and unpaid losses and settlement expenses totaling \$586.4 million. More than 94 percent of our reinsurance recoverables are due from companies rated "A-" or better by A.M. Best and S&P rating services.

The following table displays net reinsurance balances recoverable, including collateral, from our top ten reinsurers, as of December 31, 2006. All other reinsurance balances recoverable, when considered

by individual reinsurer, are less than 2 percent of shareholders' equity.

Reinsurer (amounts in thousands)	Amounts Recoverable	A.M Best Rating	S&P Rating
Munich Re America	\$136,069	A, Excellent	A-, Good
General Rein Corp	55,704	A++, Superior	AAA, Superior
Swiss Reinsurance	44,693	A+, Superior	AA-, Excellent
Berkley Insurance Company	36,397	A, Excellent	A+, Good
Lloyds of London	32,525	A, Excellent	A, Good
Endurance Reinsurance Corp.	30,275	A-, Excellent	A, Good
Toa-Re	30,014	A, Excellent	A+, Excellent
Employers Reinsurance Corp.	25,473	A+, Superior	AA-, Good
Everest Reinsurance	24,870	A+, Superior	AA-, Excellent
Liberty Mutual Insurance	20,780	A, Excellent	A, Good

6. HISTORICAL LOSS AND LAE DEVELOPMENT

The table which follows is a reconciliation of our unpaid losses and settlement expenses (LAE) for the years 2006, 2005, and 2004.

(in thousands)	2006	2005	2004
Unpaid losses and LAE at beginning of year:			
Gross	\$1,331,866	\$1,132,599	\$ 903,441
Ceded	(593,209)	(464,180)	(372,048)
Net	\$ 738,657	\$ 668,419	\$ 531,393
Increase (decrease) in incurred losses and LAE:			
Current accident year	300,292	313,643	316,948
Prior accident years	(43,403)	(62,473)	(10,817)
Total incurred	\$ 256,889	\$ 251,170	\$ 306,131
Loss and LAE payments for claims incurred:			
Current accident year	(47,994)	(43,062)	(39,206)
Prior accident year	(154,446)	(137,870)	(129,899)
Total paid	(202,440)	\$ (180,932)	\$ (169,105)
Net unpaid losses and LAE at end of year	\$ 793,106	738,657	668,419
Unpaid losses and LAE at end of year:			
Gross	1,318,777	1,331,866	1,132,599
Ceded	(525,671)	(593,209)	(464,180)
Net	\$ 793,106	\$ 738,657	\$ 668,419

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

The table below summarizes our prior accident years' loss reserve development by segment for 2006, 2005, and 2004:

(Favorable)/Unfavorable reserve development by segment (in thousands)	2006	2005	2004
Casualty	\$(40,030)	\$(57,505)	\$(11,813)
Property	(1,784)	(7,581)	(5,137)
Surety	(1,589)	2,613	6,133
Total	\$(43,403)	\$(62,473)	\$(10,817)

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

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

experienced favorable development of \$43.4 in aggregate on prior years' estimates.

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

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

property segment. We do not anticipate any further deterioration in our estimates.

2005. During 2005, we experienced an aggregate of \$62.5 million of favorable development. Of this total, approximately \$57.5 million of this reserve development occurred in the casualty segment. It was primarily from accident years 2002, 2003, and 2004 for our general liability, specialty programs, and transportation products. Pricing and policy terms and conditions rapidly became more favorable for most of our products beginning in 2002. Many of the improvements in market conditions were difficult to quantify at the time of our original estimate. Our significant growth in premium and exposures over this same time period made precise quantification of these changes more challenging because of the resulting mix changes, new exposures underwritten for the first time, and uncertainty in whether the new exposures would have similar emergence patterns as those reflected in our historical data. We appropriately reflected these significant risks in our 2002-2004 initial carried reserves for this business. During 2005, we regularly observed emergence of losses lower than expected for these accident years as the anticipated risks failed to materialize. This resulted in a re-evaluation and corresponding reduction in expected loss ratios used in the loss reserving analysis for these products. The lower than expected emergence, lower expected loss ratios, and the natural progression of increased weighting on the incurred and paid development actuarial methods caused the reserve estimate to decrease. In response to the reduction in reserve estimates, we released \$36.8 million, \$11.6 million, and \$6.3 million of IBNR loss and LAE reserves to general liability, specialty programs, and transportation, respectively. The release for these products was consistent with our loss reserving processes. These releases comprise a majority of the favorable development within our casualty segment.

The property segment also experienced \$7.6 million of favorable development. A portion of this positive development is due to the claims department reassessing and decreasing the estimated ultimate level of loss payments for the 2004 hurricanes. Overall, the surety segment experienced \$2.6 million in adverse development. Reserve additions on

surety products for the 2002 accident year exceeded favorable experience on surety products for accident years prior to 2002.

2004. During 2004, we experienced an aggregate of \$10.8 million of favorable development. Of this total, approximately \$5.1 million of favorable development occurred in the property segment. Approximately half of the favorable development within our property segment was due to a favorable settlement of an outstanding claim from the Northridge, California earthquake of 1994. The remainder relates primarily to favorable development on losses that occurred during 2003.

In 2004 the cumulative experience attributable to many of our casualty products for mature accident years was materially lower than the IBNR reserves originally booked. Due to the low emergence of loss and LAE, we released \$9.7 million of IBNR reserves during the fourth quarter of 2004, which accounted for the majority of the favorable development within our casualty segment. While we had been experiencing robust price improvements in this segment for 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.

The surety segment experienced \$6.1 million in adverse development. A portion of this development comes from contract bond products, where we increased IBNR reserves on bonds primarily written before 2003. Additionally, we experienced adverse development on reserves for other surety products, primarily related to the 2002 accident year.

ENVIRONMENTAL, ASBESTOS, AND MASS TORT EXPOSURES

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

The following table represents inception-to-date paid and unpaid environmental claims data (including incurred but not reported losses) as of December 31, 2006, 2005, and 2004:

(in thousands)	2006	2005	2004
Loss and LAE payments			
Gross	\$ 53,323	\$ 46,685	\$ 44,360
Ceded	(29,853)	(26,888)	(25,590)
Net	\$ 23,470	\$ 19,797	\$ 18,770
Unpaid losses and LAE at end of year			
Gross	\$ 48,541	\$ 47,391	\$ 43,716
Ceded	(25,720)	(30,950)	(28,998)
Net	\$ 22,821	\$ 16,441	\$ 14,718

Our environmental, asbestos, and mass tort exposure is limited, relative to that of other insurers, as a result of entering the affected liability lines after the insurance industry had already recognized environmental and asbestos exposure as a problem and adopted appropriate coverage exclusions. During 2006, we reviewed our reserves for these exposures relative to industry benchmarks and re-evaluated its emergence patterns. As a result, net reserves for these exposures were increased \$6.4 million. Other significant activity during 2006 was payment for the settlement of a large claim associated with a Superfund site. The claim arose out of commercial umbrella business written in the early 1980s. Gross payments of \$4.0 million and net payments of \$2.1 million for this claim caused the majority of the 2006 increase, reflected in the table above. This claim had no effect on 2006 incurred losses, however, because an adequate case reserve estimate had been established for it in 2004.

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

7. INCOME TAXES

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are summarized as follows:

(in thousands)	2006	2005
Deferred tax assets:		
Tax discounting of claim reserves	\$38,294	\$ 35,591
Unearned premium offset	20,315	18,831
Other	7,937	5,843
	66,546	60,265
Less valuation allowance	-	-
Total deferred tax assets	\$ 66,546	\$ 60,265
Deferred tax liabilities:		
Net unrealized appreciation of securities	\$ 57,017	\$ 44,856
Deferred policy acquisition costs	25,837	24,318
Book/tax depreciation	2,289	2,217
Undistributed earnings of unconsolidated investee	8,043	11,108
Other	429	483
Total deferred tax liabilities	93,615	82,982
Net deferred tax liability	\$(27,069)	\$(22,717)

We believe that our deferred tax assets will be fully realized through deductions against future taxable income.

Income tax expense attributable to income from operations for the years ended December 31, 2006, 2005, and 2004, differed from the amounts computed by applying the U.S. federal tax rate of 35 percent to pretax income from continuing operations as demonstrated in the following table:

(in thousands)	2006	2005	2004
Provision for income taxes at the statutory federal tax rates	\$65,413	\$50,357	\$35,120
Increase (reduction) in taxes resulting from:			
Dividends received deduction	(1,858)	(1,705)	(1,637)
ESOP dividends paid deduction	(469)	(439)	(370)
Tax-exempt interest income	(5,885)	(5,980)	(5,175)
Resolution of tax contingency	(3,171)	-	-
Goodwill	-	-	291
Other items, net	(1,776)	(5,491)	(923)
Total	\$52,254	\$36,742	\$27,306

Our net earnings include equity in earnings of unconsolidated investees. These investees (Maui Jim

and TBW) do not have a pattern of paying dividends. As a result, we record a deferred tax liability on these earnings at the corporate capital gains rate of 35 percent. In January 2007, the board of directors of Maui Jim declared a dividend that will be payable in the first quarter of 2007. Our share of the cash dividend will be \$5.9 million. As required by SFAS 109, "Accounting for Income Taxes," in 2006 we recognized a \$1.7 million tax benefit from applying the lower tax rate applicable to affiliated dividends as compared to the corporate capital gains rate on which the deferred tax liabilities were based. This benefit is included in the other items, net caption in the previous table. A dividend was also paid in 2006 by Maui Jim in the amount of \$16.5 million and a \$4.6 million tax benefit was recorded in 2005 from applying the lower tax rates. Although a dividend has been received for two straight years, we do not anticipate the payment of dividends to continue. On December 28, 2006, we sold our equity investment in TBW. This resulted in a realized capital gain of \$16.2 million with a corresponding current tax expense of \$5.7 million and the current recognition of tax expense of \$5.5 million from the previously deferred tax expense on undistributed earnings of this unconsolidated investee. Additionally, results for 2006 include a favorable resolution of a recent tax examination. During the second quarter of 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. Although the IRS is not currently examining any of our income tax returns, tax years 2005 and 2006 remain open and are subject to examination.

We have recorded our deferred tax assets and liabilities using the statutory federal tax rate of 35 percent. We believe it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax asset. In addition, we believe when these deferred items reverse in future years, our taxable income will be taxed at an effective rate of 35 percent.

Net federal and state income taxes paid in 2006, 2005, and 2004 amounted to \$53.1 million, \$47.7 million, and \$27.8 million, respectively.

During the fourth quarter of 2005, we repatriated a \$4.0 million dividend from our foreign subsidiary, RLI

Insurance, Ltd., which qualified for the special 85% dividends received deduction passed in The American Jobs Creation Act of 2004. This allowed a \$1.3 million deferred tax liability to be reversed because the dividend fully repatriated all foreign earnings. The tax benefit associated with the repatriation is included in the other items, net caption in the previous table.

8. EMPLOYEE BENEFITS

PENSION PLAN

Through 2006, we maintained a noncontributory defined benefit pension plan covering employees meeting age and service requirements. The plan provided a benefit based on a participant's service and the highest five consecutive years' average compensation out of the last 10 years. During 2006, 2005, and 2004, we made tax-deductible contributions totaling \$1.8 million, \$1.8 million, and \$0.5 million, respectively, to adequately meet the funding requirements of the plan.

We have made various amendments to the plan in order to comply with certain Internal Revenue Code changes.

Additionally, on December 31, 2003, our pension plan was amended to freeze benefit service as of March 1, 2004. As a result, we expensed the entire unrecognized prior service cost as of December 31, 2003. The plan was also closed to new participants after December 31, 2003.

However, effective December 31, 2005, the plan was further amended such that all participants' benefits were frozen and future pay would not alter a participant's accrued benefit. In 2005, we also shortened the amortization period of the plan's unrecognized gain/loss, to fully amortize it over the next two years.

The plan was terminated in 2006. All participants either elected and were paid lump sum amounts or had an insurance contract for their benefit purchased on their behalf during 2006. At the close of 2006, \$561,186 remains in the trust, of which \$559,618 was due to pension checks not cashed, and the remaining \$1,568 is the net assets remaining in the trust.

The financial status of the plan for each of the two years ended December 31 is illustrated in the following table:

(in thousands)	2006	2005
Change in benefit obligation		
Benefit obligation at January 1	\$ 11,365	\$13,781
Service cost	-	-
Interest cost	583	757
Net actuarial loss/(gain)	1,538	1,669
Benefits paid	(14,420)	(1,457)
Curtailment cost ⁽¹⁾	-	(3,385)
Settlement cost ⁽²⁾	934	-
Benefit obligation at December 31	-	\$11,365
Change in plan assets		
Fair value of plan assets at January 1	\$ 11,514	\$10,729
Actual return on plan assets	1,099	417
Employer contributions	1,809	1,825
Benefits paid	(14,420)	(1,457)
Fair value of plan assets at December 31	\$ 2	\$11,514

⁽¹⁾ At December 31, 2005 all future plan benefits were frozen which results in a curtailment.

⁽²⁾ In December 2006 all plan benefits were paid which resulted in a settlement.

The components of benefit cost for each of the three years ended December 31 is illustrated in the following table:

(in thousands)	2006	2005	2004
Service cost	\$ -	\$ -	\$ -
Interest cost	583	757	717
Expected (return) on assets	(481)	(460)	(698)
Amortization of prior service cost	-	-	-
Amortization of losses/(gains)	1,603	1,760	732
Amortization of transitional obligation/(asset)	-	-	(7)
Net periodic benefit cost	\$1,705	\$2,057	\$744
FAS 88 events ⁽¹⁾⁽²⁾	934	399	-
Total pension cost/(income) for year	\$2,639	\$2,456	\$744

⁽¹⁾ The pension plan had benefit payments in excess of the sum of service cost and interest cost. This resulted in a recognition of settlement expense in 2005.

⁽²⁾ In December 2006 all plan benefits were paid which resulted in a settlement.

The reconciliation of (accrued)/prepaid benefit cost for each of the two years ended December 31 is illustrated in the following table:

Reconciliation of (accrued)/prepaid benefit cost (in thousands)	2006	2005
(Accrued)/prepaid benefit cost (before adjustment) at beginning of year	\$ 832	\$ 1,463
Net periodic benefit (cost)/income for fiscal year	(1,705)	(2,057)
Cost of SFAS 88 events	(934)	(399)
Employer contributions	1,809	1,825
Benefits paid directly by company	-	-
Other adjustment	-	-
Amount recognized in accumulated other comprehensive income	-	-
Net balance sheet (liability)/asset at end of year	\$ 2	\$ 832

The funded status of the plan for each of the two years ended December 31 is illustrated below:

Development of funded status (in thousands)	2006	2005
Actuarial value of benefit obligations measurement date	12/31/2006	12/31/2005
Accumulated benefit obligation	\$ -	\$11,365
Projected benefit obligation/accumulated postretirement benefit obligation	-	11,365
Funded Status		
Projected benefit obligation/accumulated postretirement benefit obligation	-	11,365
Plan assets at fair value	2	11,514
Employer contribution after measurement date, before year end	-	-
Directly paid benefits after measurement date, before year end	-	-
Net balance sheet (liability)/asset	\$ 2	\$ 148
Information for plans with PBO/APBO less than plan assets (in thousands)	2006	2005
Projected benefit obligation/accumulated postretirement benefit obligation	-	\$11,365
Accumulated benefit obligation/accumulated postretirement benefit obligation	-	\$11,365
Fair value of plan assets	\$ 2	\$11,514

The change in net actuarial loss/(gain) for each of the two years ended December 31 is illustrated below:

Change in net actuarial loss/gain (in thousands)	2006	2005
Net actuarial loss/(gain) at end of prior year	\$684	\$ 4,515
Amortization credit/(cost) for year	\$(1,603)	(1,760)
Liability loss/(gain)	1,538	1,669
Asset loss/(gain)	(619)	44
Recognition of curtailment (gain)/loss	-	(3,385)
Recognition of settlement (gain)/loss	-	(399)
Other adjustments	-	-
Net actuarial loss/(gain) at year end	\$ -	\$ 684

The change in amortization expected to be recognized for each of the two years ended December 31 is illustrated below:

Amortizations expected to be recognized during next fiscal year (in thousands)	2006	2005
Amortization of net transition obligation/(asset)	\$ -	\$ -
Amortization of prior service cost/(credit)	\$ -	\$ -
Amortization of net losses/(gains)	\$ -	\$(1,760)

Actuarial assumptions, plan assets, contribution and benefit payment information, and additional information of the plan for each of the two plan years ended December 31 is illustrated below.

Actuarial assumptions	2006	2005
Weighted-average assumptions used to determine benefit obligations at year end		
Discount rate	N/A	4.75%
Rate of compensation increase	N/A	N/A
Social Security increase	N/A	N/A
Pension increases for participants in-payment status	N/A	N/A
Weighted-average assumptions used to determine net periodic benefit cost for year		
Discount rate	4.75%	5.75%
Expected long-term return on plan assets	4.75%	4.75%
Rate of compensation increase	N/A	N/A
Social Security increase	N/A	N/A
Pension increases for participants in-payment status	N/A	N/A

Plan assets	2006	2005
Allocation of assets at year end		
Equity securities	0.00%	87.00%
Debt securities	0.00%	0.00%
Real estate	0.00%	0.00%
Other	100.00%	13.00%
Total	100.00%	100.00%

Company contributions (in thousands)	2006	2005
Company contributions for the year ending:		
December 31, 2005	0	\$1,825
December 31, 2006	\$1,809	N/A
December 31, 2007 (estimated)	N/A	N/A
Actual benefit payments for the year ending:		
December 31, 2005	0	\$1,457
December 31, 2006	\$14,420	0

Additional information

Balance sheet entries under prior rules (in thousands)	2006	2005
Statement of financial position prior to deferred tax adjustments:		
(Accrued)/prepaid as of end of year	\$ 2	N/A
Additional minimum liability	-	N/A
Intangible asset	-	N/A
Accumulated other comprehensive income using prior rules	-	N/A
Accumulated other comprehensive income using new rules	-	N/A

In September 2006, the FASB published SFAS 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." This statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. As previously stated, the plan was terminated in 2006. As a result, the implementation of SFAS 158 had no impact on our financial statements.

EMPLOYEE STOCK OWNERSHIP, 401K AND BONUS AND INCENTIVE PLANS

We maintain an Employee Stock Ownership Plan (ESOP), 401k, and bonus and incentive plans covering executives, managers, and associates. At the board's discretion, funding of these plans is primarily dependent upon reaching predetermined levels of operating return on equity and Market Value Potential (MVP). While some management incentive plans may be affected somewhat by other performance factors, the larger influence of corporate performance ensures that the interests of our executives, managers, and associates correspond with those of our shareholders.

In January 2004, we made certain changes to our employee benefit plans. We froze our pension plan, modified our ESOP plan, and began offering a 401k plan. The 401k plan has eligibility rules similar to those in place for our ESOP, allows voluntary contributions by employees, and permits ESOP diversification transfers for employees meeting certain age and service requirements. We provide a basic 401k contribution of 3 percent of eligible compensation. Participants are 100 percent vested in both voluntary and basic contributions. Additionally, an annual discretionary profit-sharing contribution may be made to the ESOP and 401k, subject to the achievement of certain overall financial goals. For plan years prior to 2007, profit-sharing contributions were subject to a five-year cliff vest. Beginning in 2007, contributions will vest after three years of service.

Our ESOP and 401k cover substantially all employees meeting eligibility requirements. ESOP and 401k contributions are determined annually by our board of directors and are expensed in the year earned. ESOP and 401k-related expenses were \$7.9 million, \$7.7 million, and \$6.4 million, respectively, for 2006, 2005, and 2004.

During 2006, the ESOP purchased 94,430 shares of RLI stock on the open market at an average price of \$54.19 (\$5.1 million) relating to 2005's contribution. Shares held by the ESOP as of December 31, 2006, totaled 1,716,446, and are treated as outstanding in computing our earnings per share. During 2005, the ESOP purchased 95,762 shares on the open market at an average price of \$44.55 (\$4.3 million) relating to 2004's contribution. During 2004, the ESOP purchased 131,700 shares on the open market at

an average price of \$40.57 (\$5.3 million) relating to 2003's contribution.

A portion of both MVP and operating earnings is shared by executives, managers, and associates provided certain thresholds are met. MVP, in particular, requires that we generate a return in excess of our cost of capital before the payment of such bonuses. Annual expenses for these bonus plans totaled \$15.1 million, \$9.2 million, and \$6.8 million for 2006, 2005, and 2004, respectively.

DEFERRED COMPENSATION

We maintain Rabbi Trusts for deferred compensation plans for directors, key employees, and executive officers through which our shares are purchased. The Emerging Issues Task Force consensus on Issue 97-14 governs the accounting for Rabbi Trusts. This issue prescribed an accounting treatment whereby the employer stock in the plan is classified and accounted for as equity, in a manner consistent with the accounting for treasury stock. The deferred compensation obligation is classified as an equity instrument.

The expense associated with funding these plans is recognized through salary, bonus, and ESOP expenses for key employees and executive officers. The expense recognized from the directors' deferred plan was \$0.4 million, \$0.3 million, and \$0.4 million in 2006, 2005, and 2004, respectively.

In 2006, the trusts purchased 13,913 shares of our common stock on the open market at an average price of \$51.61 (\$0.7 million). In 2005, the trusts purchased 23,744 shares of common stock on the open market at an average price of \$44.83 (\$1.1 million). In 2004, the trusts purchased 20,421 shares of common stock on the open market at an average price of \$39.05 (\$0.8 million). At December 31, 2006, the trusts' assets were valued at \$24.4 million.

STOCK OPTION AND STOCK PLANS

During 1995, we adopted and the shareholders approved a tax-favored incentive stock option plan (the incentive plan). During 1997, the shareholders approved the Outside Directors' Stock Option Plan (the directors' plan). Normal vesting for options granted was pro rata over five years under the incentive plan and pro rata over three years under the directors' plan with a 10-year life for both plans. The plans

provided for grants of up to 3,125,000 shares under the incentive plan and 500,000 shares under the directors' plan. Through May 5, 2005, we had granted 2,640,188 options under these plans.

During 2005, our shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). In conjunction with the adoption of this plan, effective May 5, 2005, options will no longer be granted under the two other option plans previously in existence. The purpose of the omnibus plan is to promote the interests of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a high level of corporate performance and to encourage our continued success and growth. Awards under the omnibus plan may be in the form of restricted stock, stock options (both incentive and nonqualified), stock appreciation rights, performance units, as well as other stock based awards. Eligibility under the omnibus plan is limited to our employees or employees of any affiliate and to individuals or entities who are not employees but who provide services to us or an affiliate, including services provided in the capacity of consultant, advisor or director. The granting of awards is solely at the discretion of the executive resources committee and the nominating/corporate governance committee of our board of directors. The total number of shares of common stock available for distribution under the omnibus plan may not exceed 1,500,000 shares (subject to adjustment for changes in our capitalization). In 2005, we granted 233,500 stock options under this plan. In 2006, we granted 206,300 stock options under this plan.

Under the omnibus plan, we grant to officers, directors, and other employees stock options for shares with an exercise price equal to the fair value of the shares at the date of grant. Options generally vest and become exercisable ratably over a five-year period and have a 10-year life. The related compensation expense is recognized over the requisite service period. In most instances, the requisite service period and vesting period will be the same. For participants who are retirement eligible, defined by the plan as those individuals whose age and years of service equals 75, the requisite service period is deemed to be met and options are immediately expensed on the date of grant. For participants who will become retirement eligible during the vesting period, the

requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.

During 2005, our board of directors adopted resolutions authorizing the accelerated vesting of existing unvested stock options, including directors' stock options. These resolutions were effective May 5, 2005, for all options issued prior to this date and December 30, 2005, for options issued in 2005 subsequent to May 5, 2005. Acceleration was applicable to substantially all unvested options and contains certain share transfer restrictions. These modifications, which occurred prior to the effective date of SFAS 123R, effectively removed these options from expense consideration under SFAS 123R. Under APB 25, compensation expense recorded for accelerated vesting was measured by applying two criteria: (1) the difference between the market price and the option exercise price on the date of acceleration and (2) the number of options that would have been forfeited as unexercisable (unvested) had acceleration not occurred. Using the guidance set forth in APB 25 and related interpretations, we recorded \$0.8 million of pre-tax compensation expense during 2005. This expense represented our best estimate of the total expense associated with acceleration.

The following tables summarize option activity in 2006, 2005, and 2004:

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2006	1,931,627	\$26.53		
Options granted	206,300	\$50.31		
Options exercised	(459,828)	\$18.98		\$15,997
Options cancelled/ forfeited	(46,080)	\$39.48		
Outstanding options at December 31, 2006	1,632,019	\$31.30	5.75	\$41,015
Exercisable options at December 31, 2006	1,429,219	\$28.59	5.23	\$39,770

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2005	2,058,632	\$22.78		
Options granted	238,300	\$44.64		
Options exercised	(340,099)	\$15.83		\$10,068
Options cancelled/ forfeited	(25,206)	\$35.98		
Outstanding options at December 31, 2005	1,931,627	\$26.53	5.05	\$45,085
Exercisable options at December 31, 2005	1,924,787	\$26.50	5.04	\$44,991

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2004	1,953,848	\$19.95		
Options granted	313,240	\$35.62		
Options exercised	(200,656)	\$15.02		\$4,664
Options cancelled/ forfeited	(7,800)	\$27.74		
Outstanding options at December 31, 2004	2,058,632	\$22.78	5.16	\$38,680
Exercisable options at December 31, 2004	1,219,412	\$17.84	3.86	\$28,931

The majority of our options are granted annually at the board meeting in May. In 2006, 206,300 options were granted with an average exercise price of \$50.31 and an average fair value of \$13.95. Of these grants, 171,900 were granted at the board meeting in May with a calculated fair value of \$13.97. We recognized \$0.8 million of expense during 2006 related to 2006 grants. Since options granted in 2006 have been non-qualified, we recorded a tax benefit of \$0.3 million related to this compensation expense. Total unrecognized compensation expense relating to these grants was \$1.9 million, which will be recognized over the remainder of the five-year vesting period. There were no options that vested during 2006.

The fair value of options were estimated using a Black-Scholes based option pricing model with the following grant-date assumptions and weighted average fair values:

	2006	2005	2004
Weighted-average fair value of grants	\$13.95	\$13.08	\$10.62
Risk-free interest rates	4.99%	3.97%	4.55%
Dividend yield	1.51%	1.52%	1.79%
Expected volatility	22.35%	22.93%	21.46%
Expected option life	6.31 years	8.0 years	9.0 years

The risk-free rate is determined based on U.S. treasury yields that most closely approximate each options expected life. The dividend yield is calculated based on the average annualized dividends paid during the most recent five-year period. The expected volatility is an implied volatility. For 2006, this volatility is calculated by computing the weighted average of the most recent one-year volatility, the most recent 6.31-year (equal to the expected life) volatility and the median of the 6.31-year rolling volatilities of RLI stock. For 2006, the expected option life is determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant. In prior years, the expected life was determined using historical exercise patterns.

As discussed previously, prior to the adoption of SFAS 123R, we followed the intrinsic value method in accordance with APB 25 to account for employee stock options and accordingly recognized no compensation expense for the stock option grants. In accordance with SFAS 123R, we adopted the provisions of the statement on January 1, 2006 using the modified prospective approach. Under this method, prior periods are not restated. Had compensation cost for share-based plans been determined consistent with SFAS 123R, our net earnings and earnings per share for the years ended December 31, 2005 and 2004 would have been reduced to the pro forma amounts that follow:

(in thousands, except per share data)	2005	2004
Net earnings, as reported	\$107,134	\$73,036
Add: Stock-based employee compensation expense included in reported earnings, net of related tax effects	553	—
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(4,592)	(1,941)
Pro forma net earnings	\$103,095	\$71,095
Earnings per share:		
Basic - as reported	\$4.21	\$2.90
Basic - pro forma	\$4.05	\$2.82
Diluted - as reported	\$4.07	\$2.80
Diluted - pro forma	\$3.92	\$2.72

Pro forma disclosures for 2006 are not presented because the amounts are recognized in the statement of earnings.

During 2004, the shareholders approved the NonEmployee Directors' Stock Plan (stock plan). An aggregate of 200,000 shares of common stock is reserved under the stock plan. The stock plan is designed to provide compensation to each nonemployee director in the form of a stock grant at the time of such director's election or appointment to the board of directors, and future stock grants based on continued service as a director. In conjunction with the shareholders' approval of the omnibus plan in May 2005, no further awards will be issued under the stock plan. Awards to outside directors will be made under the omnibus plan.

Shares granted to outside directors were 7,267 in 2006 and 5,642 in 2005. Shares were granted at an average share price of \$51.72 in 2006 and \$45.75 in 2005. In 2006, 3,452 of the shares granted were issued under the directors' deferred plan. We recognized \$0.4 million of expense, relating to these grants.

POST-RETIREMENT BENEFITS OTHER THAN PENSION

In 2002, we began offering certain eligible employees post-employment medical coverage. Under our plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under our health plan. Former employees who elect continuation of coverage pay the

full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. We expect a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees covers the cost of providing this coverage.

9. STATUTORY INFORMATION AND DIVIDEND RESTRICTIONS

Our insurance subsidiaries maintain their accounts in conformity with accounting practices prescribed or permitted by state insurance regulatory authorities that vary in certain respects from GAAP. In converting from statutory to GAAP, typical adjustments include deferral of policy acquisition costs, the inclusion of statutory nonadmitted assets, and the inclusion of net unrealized holding gains or losses in shareholders' equity relating to fixed maturities.

Year-end statutory surplus includes \$44.0 million of RLI Corp. stock (cost basis of \$63.1 million) held by Mt. Hawley Insurance Company. The Securities Valuation Office provides specific guidance for valuing this investment, which is eliminated in our consolidated financial statements.

In December 2003, we closed a public debt offering of \$100.0 million, generating \$98.9 million in net proceeds. Of these proceeds, \$50.0 million was contributed to the insurance subsidiaries to bolster statutory surplus. In March 2004, an additional \$15.0 million of these proceeds was contributed to the insurance subsidiaries.

The following table includes selected information for our insurance subsidiaries as filed with insurance regulatory authorities:

(in thousands)			
Year ended December 31,	2006	2005	2004
Consolidated net income, statutory basis	\$136,135	\$ 95,776	\$ 62,189
Consolidated surplus, statutory basis	\$746,905	\$690,547	\$605,967

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 authorities of Illinois. The maximum dividend distribution is limited by Illinois

law to the greater of 10 percent of RLI policyholder surplus as of December 31 of the preceding year or the net income of RLI for the 12-month period ending December 31 of the preceding year. RLI's stand-alone net income for 2006 was \$75.7 million. Therefore, the maximum dividend distribution that can be paid by RLI during 2007 without prior approval is \$75.7 million — RLI's 2006 net income. Dividends paid in the form of asset transfers are applied to the dividend limitation at the estimated fair value of the asset as of the dividend date. In 2006, a total of \$59.5 million was paid in dividends by RLI Insurance 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. This left \$16.2 million in unused dividend capacity for 2006. The total amount paid in 2005 was \$13.0 million.

10. COMMITMENTS AND CONTINGENT LIABILITIES

The following is a description of a complex set of litigation wherein we are both a plaintiff and a defendant. While it is impossible to ascertain the ultimate outcome of this matter at this time, we believe, based upon facts known to date, that our position is meritorious. Our opinion is that the final resolution of these matters will not have a material adverse effect on our financial statements taken as a whole.

We are the plaintiff in an action captioned RLI Insurance Co. v. Commercial Money Center, which was filed in U.S. District Court, Southern District of California (San Diego) on February 1, 2002. Other defendants in that action are Commercial Servicing Corporation ("CSC"), Sterling Wayne Pirtle, Anita Pirtle, Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank and Sky Bank. We filed a similar complaint against the Bank of Waukegan in San Diego, California Superior Court. Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, Sky Bank and Bank of Waukegan are referred to here as the "investor banks." The litigation arises out of the equipment and vehicle leasing program of Commercial Money Center ("CMC"). CMC originated leases, procured bonds pertaining to the performance of obligations of each lessee under each lease, and then formed "pools" of such leases that it marketed to banks and other institutional investors. We sued for rescission and/or exoneration of the bonds we

issued to CMC and sale and servicing agreements we entered into with CMC and the investor banks, which had invested in CMC's equipment leasing program. We contend we were fraudulently induced to issue the bonds and enter into the agreements by CMC, who misrepresented and concealed the true nature of its program and the underlying leases originated by CMC (for which bonds were procured). We also sued for declaratory relief to determine our rights and obligations, if any, under the instruments. Each investor bank disputes our claims for relief. CMC is currently in Chapter 7 bankruptcy proceedings.

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

In the third quarter of 2005, RLI reached a confidential settlement agreement with Lakeland Bank. This settlement ends our litigation with Lakeland, but does not resolve our pending litigation with the four other investor banks. The settlement with Lakeland relates to surety bonds representing approximately 17 percent of the amount to which the five investor banks had claimed entitlement. The settlement did not have a material adverse effect on our financial statements taken as a whole. In addition, in August 2005, the Federal District Court denied outright the investor banks' motion for judgment on the pleadings as to RLI and subsequently ordered all remaining cases to mandatory mediation. Mediations held in January

2006 between RLI and each of the four remaining investor banks did not resolve the claims of those investor banks. In September 2006, the Court issued a case management order governing expert witness discovery and future motion practice. While we cannot predict the ultimate outcome of the pending litigation between RLI and the remaining four investor banks at this time, RLI continues to believe it has meritorious defenses with respect to each of the banks making claims against it and will continue to vigorously assert those defenses in the pending litigation.

Our financial statements contain an accrual for defense costs relating to this matter, included in unpaid losses and settlement expenses, as well as an accrual to cover rescission of collected premium related to the program. In our opinion, final resolution of this matter will not have a material adverse effect on our financial condition, results of operations or cash flows. However, litigation is subject to inherent uncertainties, and if there were an outcome unfavorable to us, there exists the possibility of a material adverse impact on our financial condition, results of operation or cash flows in the period in which the outcome occurred.

In addition, we are party to numerous claims and losses that arise in the normal course of our business. Many of such claims or losses involve claims under policies that we underwrite as an insurer. We believe that the resolution of these claims and losses will not have a material adverse effect on our financial condition, results of operations or cash flows.

We have capital lease obligations for leased computers and operating lease obligations for regional office facilities. These leases expire in various years through 2013. Expense associated with these leases totaled \$3.4 million in 2006, \$2.7 million in 2005 and \$2.0 million in 2004. Minimum future rental payments under noncancellable leases are as follows:

(in thousands)	
2007	\$ 3,516
2008	2,737
2009	2,455
2010	2,149
2011	1,539
2012-2013	1,983
Total minimum future rental payments	\$14,379

11. INDUSTRY SEGMENT INFORMATION

The following table summarizes our segment data as specified by SFAS 131, "Disclosures about Segments of an Enterprise and Related Information." As prescribed by the pronouncement, reporting is based on the internal structure and reporting of information as it is used by management.

The segments of our insurance operations include property, casualty, and surety. The property segment is comprised of insurance coverages providing physical damage coverage for commercial and personal risks. These risks are exposed to a variety of perils including earthquakes, fires, and hurricanes. Losses are developed in a relatively short period of time.

The casualty segment includes liability coverages where loss and related settlement expenses must be estimated, as the ultimate disposition of claims may take several years to fully develop. Policy coverage is more significantly impacted by evolving legislation and court decisions.

The surety segment offers a selection of small and medium-size commercial coverages related to the statutory requirement for bonds on construction and energy-related projects. The results of this segment are generally characterized by relatively low loss ratios. Expense ratios tend to be higher due to the high volume of transactions at lower premium levels.

Net investment income is the by-product of the interest and dividend income streams from our investments in fixed-income and equity securities. Interest and general corporate expenses include the cost of debt and other director and shareholder relations costs incurred for the benefit of the corporation, but not attributable to the operations of our insurance segments. Investee earnings represent our share in Maui Jim and TBW earnings. We own approximately 40 percent of Maui Jim, which operates in the sunglass and optical goods industries, and, up until the sale in December, 2006, 21 percent of TBW, a mortgage origination company; both companies are private.

The following table provides financial data used by management. The net earnings of each segment are before taxes, and include revenues (if applicable), direct product or segment costs (such as commissions, claims costs, etc.), as well as allocated support costs from various overhead departments. While depreciation and amortization charges have been included in these measures via our expense allocation system, the related assets are not allocated for management use and, therefore, are not included in this schedule.

(in thousands)	Revenues			Depreciation and Amortization		
	2006	2005	2004	2006	2005	2004
Casualty	\$348,217	\$358,893	\$365,617	\$2,086	\$1,901	\$1,671
Property	122,581	80,528	98,043	963	993	1,063
Surety	59,540	51,886	47,688	501	450	1,263
Segment totals before income taxes	\$530,338	\$491,307	\$511,348	\$3,550	\$3,344	\$3,997
Net investment income	71,325	61,641	54,087			
Net realized gains	31,045	16,354	13,365			
Total	\$632,708	\$569,302	\$578,800			

(in thousands)	Net Earnings (Losses)		
	2006	2005	2004
Casualty	\$ 68,393	\$ 72,024	\$ 19,560
Property	4,988	(8,342)	20,400
Surety	10,675	5,201	(69)
Net Underwriting Income	\$ 84,056	\$ 68,883	\$ 39,891
Net investment income	71,325	61,641	54,087
Realized gains	31,045	16,354	13,365
General corporate expense and interest on debt	(14,650)	(13,898)	(12,430)
Equity in earnings of unconsolidated investees	15,117	10,896	5,429
Total earnings before income taxes	\$ 186,893	\$ 143,876	\$ 100,342
Income taxes	52,254	36,742	27,306
Total	\$ 134,639	\$ 107,134	\$ 73,036

The following table further summarizes revenues by major product 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

12. UNAUDITED INTERIM FINANCIAL INFORMATION

Selected quarterly information is as follows:

(in thousands, except per share data)	First	Second	Third	Fourth	Year
2006					
Net premiums earned	\$ 127,387	\$ 125,867	\$ 138,245	\$ 138,839	\$ 530,338
Net investment income	16,708	17,556	18,316	18,745	71,325
Net realized investment gains	4,442	1,489	2,822	22,292	31,045
Earnings before income taxes	36,263	27,506	43,562	79,562	186,893
Net earnings	25,656	22,922	30,378	55,683	134,639
Basic earnings per share ⁽¹⁾	\$ 1.00	\$ 0.91	\$ 1.24	\$ 2.29	\$ 5.40
Diluted earnings per share ⁽¹⁾	\$ 0.97	\$ 0.89	\$ 1.21	\$ 2.23	\$ 5.27
2005					
Net premiums earned	\$ 124,040	\$ 123,674	\$ 126,129	\$ 117,464	\$ 491,307
Net investment income	14,612	14,666	15,855	16,508	61,641
Net realized investment gains	2,984	4,389	7,194	1,787	16,354
Earnings before income taxes	41,540	49,609	35,680	17,047	143,876
Net earnings	29,307	34,395	25,327	18,105	107,134
Basic earnings per share ⁽¹⁾	\$ 1.15	\$ 1.35	\$ 0.99	\$ 0.71	\$ 4.21
Diluted earnings per share ⁽¹⁾	\$ 1.12	\$ 1.31	\$ 0.96	\$ 0.68	\$ 4.07

⁽¹⁾ Since the weighted-average shares for the quarters are calculated independently of the weighted-average shares for the year, quarterly earnings per share may not total to annual earnings per share.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
RLI Corp.:

We have audited management's assessment, included in the accompanying Report on Controls and Procedures, that RLI Corp. and Subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance

with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2006 and 2005, and the related consolidated statements of earnings and comprehensive earnings, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated February 28, 2007 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Chicago, Illinois
February 28, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
RLI Corp.:

We have audited the accompanying consolidated balance sheets of RLI Corp. and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of earnings and comprehensive earnings, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 28, 2007 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

KPMG LLP

Chicago, Illinois
February 28, 2007

STATEMENT OF FINANCIAL REPORTING RESPONSIBILITY

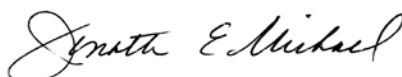
The management of RLI Corp. and Subsidiaries is responsible for the preparation and for the integrity and objectivity of the accompanying financial statements and other financial information in this report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include amounts that are based on management's estimates and judgments.

Management has established and maintains internal control throughout its operations that is designed to provide assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use, and the execution and recording of transactions in accordance with management's authorization. Internal control provides for appropriate division of responsibility and is documented by written policies and procedures that are updated by management as necessary. Management considers the recommendations of its internal auditor and independent public accounting firm concerning the Company's internal control and takes the necessary actions that are cost effective in the circumstances to respond appropriately to the recommendations presented.

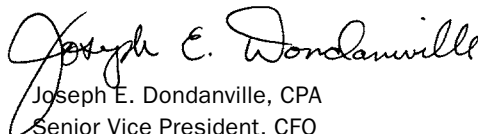
The accompanying financial statements have been audited by KPMG LLP (KPMG), an independent

registered public accounting firm selected by the audit committee and approved by the shareholders. Management has made available to KPMG all of the Company's financial records and related data, including minutes of directors' meetings. Furthermore, management believes that all representations made to KPMG during its audit were valid and appropriate.

The audit committee is comprised of four independent directors and is charged with general supervision of the audits, examinations and inspections of the books and accounts of RLI Corp. and Subsidiaries. The independent registered public accounting firm and the internal auditor have ready access to the audit committee.



Jonathan E. Michael
President, CEO



Joseph E. Dondanville, CPA
Senior Vice President, CFO

REPORT ON CONTROLS AND PROCEDURES

CONCLUSION REGARDING THE EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES

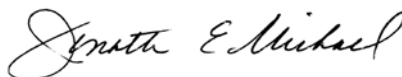
Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act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

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

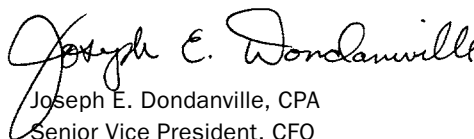
Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal

Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in Internal Control — Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2006.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by KPMG, an independent registered public accounting firm, as stated in their report which is included herein.



Jonathan E. Michael
President, CEO



Joseph E. Dondanville, CPA
Senior Vice President, CFO