MANAGEMENT'S DISCUSSION AND ANALYSIS

OVERVIEW

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

The foundation of our overall business strategy is to underwrite for profit, and we have achieved this for 12 consecutive years, averaging an 88.9 combined ratio over that period of time. This drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio, and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly rated, investment grade securities to protect invested assets. Regular underwriting income allows a portion of our shareholders' equity to be invested in equity securities. Our equity portfolio consists of a core stock portfolio weighted toward dividend-paying stocks, as well as preferred stock, real estate investment trusts (REITs), exchange traded funds (ETF), and mutual funds. Private equity investments, primarily our minority ownership in Maui Jim, Inc. (Maui Jim), have also enhanced overall returns. Additional asset classes for diversification are also being considered. In addition, we employ stringent diversification rules and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite fluctuations of realized and unrealized gains and losses in the equity portfolio, our investment in equity securities as part of a long-term asset allocation strategy has contributed significantly to our historic growth in book value.

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

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

Our property segment primarily underwrites commercial fire, earthquake, difference in conditions, marine, facultative reinsurance, and in the state of Hawaii, select personal lines policies. Property insurance results are subject to the variability introduced by perils such as earthquakes, fires, and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by purchasing reinsurance and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

The surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. We offer miscellaneous and contract surety bonds, including fidelity and court sureties. Often, our surety coverages involve a statutory requirement for bonds. While these bonds have maintained a relatively low loss ratio, losses may fluctuate due to adverse economic conditions that may affect the financial viability of an insured. The contract surety marketplace guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic conditions, inclement weather conditions or the deterioration of a contractor's financial condition. As such, this line has historically produced marginally higher loss ratios than other surety lines.

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

GAAP AND NON-GAAP FINANCIAL PERFORMANCE METRICS

Throughout this annual report, we present our operations in the way we believe will be most meaningful, useful, and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP (accounting principles generally accepted in the United States of America) presentation of net income and certain statutory reporting information, we show certain non-GAAP financial measures that we believe are valuable in managing our business and drawing comparisons to our peers. These measures are underwriting income, gross premiums written, net premiums written, combined ratios, and net unpaid loss and settlement expenses.

Following is a list of non-GAAP measures found throughout this report with their definitions, relationships to GAAP measures, and explanations of their importance to our operations.

Underwriting Income

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

Gross premiums written

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

Net premiums written

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

Combined ratios

This ratio is a common industry measure of profitability for any underwriting operation, and is calculated in two components. First, the loss ratio is losses and settlement expenses divided by net premiums earned. The second component, the expense ratio, reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss. For example, a combined ratio of 85 implies that for every $100 of premium we earn, we record $15 of underwriting income.

Net unpaid loss and settlement expenses

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

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

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

CRITICAL ACCOUNTING POLICIES

LOSSES AND SETTLEMENT EXPENSES

Overview

Loss and loss adjustment expense (LAE) reserves represent our best estimate of ultimate amounts for losses and related settlement expenses from claims that have been reported but not paid, and those losses that have occurred but have not yet been reported to us. Loss reserves do not represent an exact calculation of liability, but instead represent our estimates, generally utilizing individual claim estimates and actuarial expertise and estimation techniques at a given accounting date. The loss reserve estimates are expectations of what ultimate settlement and administration of claims will cost upon final resolution. These estimates are based on facts and circumstances then known to us, review of historical settlement patterns, estimates of trends in claims frequency and severity, projections of loss costs, expected interpretations of legal theories of liability, and many other factors. In establishing reserves, we also take into account estimated recoveries, reinsurance, salvage, and subrogation. The reserves are reviewed regularly by a team of actuaries we employ.

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

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

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

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

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

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

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

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

All decisions regarding our best estimate of ultimate loss and LAE reserves are made by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at December 31, 2007, make a reasonable provision to meet our future obligations.

Initial IBNR Generation Process

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

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

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

- significant changes in underlying policy terms and conditions,
- a new business,
- significant exposure growth or turnover,
- small volume or lacking internal data requiring significant reliance on external data,
- longer emergence patterns with exposures to latent unforeseen mass tort,
- high severity and/or low frequency,
- operational processes undergoing significant change, and/or
- high sensitivity to significant swings in loss trends or economic change.

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

Loss and LAE Reserve Estimation Process

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

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

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

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

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

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

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

- loss payment patterns,
- loss reporting patterns,
- frequency and severity trends,
- underlying policy terms and conditions,
- business or exposure mix,
- operational or internal process changes affecting timing of recording transactions,
- regulatory and legal environment, and/or
- economic environment.

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

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

Given the significant impact of the reserve estimates on our financial statements, we subject the reserving process to significant diagnostic testing. We have incorporated data validity checks and balances into our front-end processes. Leading indicators such as actual versus expected emergence and other diagnostics are also incorporated into the reserving processes.

Determination of Our Best Estimate

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

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

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

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

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

Our best estimate of our loss and LAE reserves may change depending on a revision in the actuarial point estimate, the actuary’s certainty in the estimates and processes, and our overall view of the underlying risks. From time to time, we benchmark our reserving policies and procedures and update them by adopting industry best practices where appropriate. As previously disclosed in our third quarter, 2007 quarterly report on Form 10-Q, such a review was undertaken in 2007. We performed a detailed, ground-up analysis of the actuarial estimation risks associated with each of our products and segments, including an assessment of industry information.

Based on this review, we have made certain refinements to our reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves through increased internal dialogue among the claim, underwriting, risk management and actuarial departments, greater transparency of the actuarial process and results, and improved reserving diagnostics. Overall, these enhancements and improved information provide better and faster feedback to management regarding loss development resulting in greater overall confidence in the actuarial estimates. This and the increased stability in our business in the last few years have diminished the needed level of carried reserves above the actuarial point estimate. We believe that these reserve methodology enhancements have improved the overall accuracy of our best estimate of loss and LAE reserves. In 2007, over half of the favorable development on prior years' loss reserves was the result of the ground-up risk assessment and subsequent refinements to our methodologies and estimates.

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

INVESTMENT VALUATION

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

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

We regularly evaluate our fixed income and equity securities to determine impairment losses for other-than-temporary declines in the fair value of the investments. Criteria considered during this process include, but are not limited to: the current fair value as compared to the cost (amortized, in certain cases) of the security, degree and duration of the security's fair value being below cost, credit quality, current economic conditions, the anticipated speed of cost recovery, and our decisions to hold or divest a security. 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:

- credit ratings from major rating agencies, including Moody's and Standard & Poor's (S&P),
- business and operating performance trends,
- management quality/turnover,
- industry competitive analysis, and
- changes in business model/strategy.

Part of our evaluation of whether particular securities are other-than-temporarily impaired involves assessing whether we have both the intent and ability to continue to hold securities in an unrealized loss position. Significant changes in these factors could result in a charge to net earnings for impairment losses. Impairment losses result in a reduction of the underlying investment's cost basis.

RECOVERABILITY OF REINSURANCE BALANCES

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, rather than being netted with the related liabilities, since reinsurance does not relieve us of our liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. Additionally, the same uncertainties associated with estimating unpaid losses and settlement expenses impact the estimates for the ceded portion of such liabilities. We continually monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements and Securities and Exchange Commission filings. We also review insurance industry developments that may impact the financial condition of our reinsurers. We analyze the credit risk associated with our reinsurance balances recoverable by monitoring the A.M. Best and S&P ratings of our reinsurers. In addition, we subject our reinsurance recoverables to detailed recoverability tests, including one based on average default by S&P rating. Based upon our review and testing, our policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that we may be unable to recover. Further discussion of our reinsurance balances recoverable can be found in note 5 to the financial statements.

DEFERRED POLICY ACQUISITION COSTS

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

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

RESULTS OF OPERATIONS

Consolidated revenue for 2007 was $652.3 million compared to $632.7 million in 2006 and $569.3 million in 2005. Revenue for 2007 and 2006 benefited from gains in the insurance operations' premiums earned, as well as increased net investment income. Net premiums earned advanced for 2007 and 2006 as the significant growth in premium writings in our property segment during each of the preceding years was earned as revenue. In addition, net investment income grew in each of the last two years as investment yields improved and our invested asset base was higher. Realized gains have also contributed significantly to revenue over the past two years. Results in 2007 reflect gains associated with the sale of certain equity securities deemed to have reached their full potential. Funds received were used to further diversify the investment portfolio. Realized gains in 2006 increased largely due to the sale of the equity in one of our investee holdings.

CONSOLIDATED REVENUE	Year ended December 31,		
(in thousands)	**2007**	2006	2005
Net premiums earned	**$544,478**	$530,338	$491,307
Net investment income	**78,901**	71,325	61,641
Net realized investment gains	**28,966**	31,045	16,354
Total consolidated revenue	**$652,345**	$632,708	$569,302

Net earnings for 2007 and 2006 represented consecutive record earnings as both underwriting and investment income improved. Included in underwriting income were the effects of favorable development on prior years' loss reserves. The more significant of these developments occurred in our casualty and surety segments. In 2007, favorable development on prior accident years' casualty and surety reserves totaled $98.5 million.

As discussed more fully in the "Losses and Settlement Expenses" section within our Critical Accounting Policies, we performed a detailed analysis of recent favorable loss trends and reserve risk factors in 2007. Our review included an assessment of industry information. The review resulted in certain refinements and enhancements to our reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves. Overall, the enhancements and improved information provide better and faster feedback to management regarding loss development, resulting in greater overall confidence in the actuarial estimates. This, and the increased stability in our business in the last few years, have diminished the needed level of carried reserves above the actuarial point estimate. We believe that these reserve methodology enhancements have improved the overall accuracy of our best estimate of loss and LAE reserves. Over half of the favorable prior years' loss development recorded in 2007 was the result of this detailed assessment and resulting changes in our booked reserves.

In 2006 and 2005, underwriting income included favorable development on prior accident years' loss reserves of $43.4 million and $62.5 million, respectively, predominately from the casualty segment.

Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital). Bonus and profit sharing-related expenses related to the aforementioned favorable prior years' reserve developments totaled $9.9 million, $3.5 million, and $4.2 million, respectively, for 2007, 2006 and 2005. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses.

Investee earnings declined in 2007 due in large part to the fourth quarter 2006 sale of the equity in one of our investee holdings.

NET EARNINGS (in thousands)	**2007**	2006	2005
Underwriting income	**$ 155,765**	$ 84,056	$ 68,883
Net investment income	**78,901**	71,325	61,641
Net realized investment gains	**28,966**	31,045	16,354
Debt interest	**(6,997)**	(6,581)	(7,118)
Corporate expenses	**(9,474)**	(8,069)	(6,780)
Investee earnings	**7,315**	15,117	10,896
Pretax earnings	**$254,476**	$186,893	$143,876
Income tax	**(78,609)**	(52,254)	(36,742)
Net earnings	**$175,867**	$134,639	$107,134

Comprehensive earnings were $166.4 million in 2007 compared to $157.0 million a year ago and $83.9 million in 2005. For the equity portfolio, the change in unrealized gains was negative in 2007 and 2005, while the change was positive in 2006. In the fixed income portfolio, the unrealized change was positive in 2007 and 2006, while negative in 2005.

RLI INSURANCE GROUP

In general, we have experienced continued softening in the marketplace over the last several years. As reflected in the table below, premium writings were down in 2007. Increased competition and capacity in the marketplace have resulted in rate declines in our casualty and property segments. In addition, targeted reductions in our catastrophe exposure resulted in reduced property writings in 2007, as we continue to manage our exposure to catastrophic events (wind and earthquake). In 2006, we posted moderate growth overall, as the property segment saw significant premium increases through the first three quarters of the year. Rates in catastrophe-prone areas, particularly those exposed to wind, were up markedly during this period. Wind rates softened toward the end of 2006. Underwriting income was up considerably in our insurance operations for both 2007 and 2006. Strong underwriting results for the casualty and surety segments were magnified by favorable development on prior accident years' loss reserves. The property segment benefited from light hurricane seasons in 2007 and 2006, following a severe hurricane season in 2005. In addition, loss frequency and severity declined in 2007, particularly with respect to the discontinued construction program and habitational fire coverages. The following table and narrative provide a more detailed look at individual segment performance over the last three years.

GROSS PREMIUMS WRITTEN

(in thousands)	**2007**	2006	2005
Casualty	**$462,591**	$506,887	$519,115
Property	**206,041**	225,610	176,228
Surety	**70,702**	66,516	60,669
Total	**$739,334**	$799,013	$756,012

UNDERWRITING INCOME (LOSS)

(in thousands)	**2007**	2006	2005
Casualty	**$101,863**	$ 68,393	$ 72,024
Property	**30,569**	4,988	(8,342)
Surety	**23,333**	10,675	5,201
Total	**$155,765**	$ 84,056	$ 68,883

COMBINED RATIO	**2007**	2006	2005
Casualty	**70.3**	80.4	80.0
Property	**77.9**	95.9	110.3
Surety	**62.8**	82.1	90.0
Total	**71.4**	84.1	86.0

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

(in thousands)	**2007**	2006	2005
CASUALTY			
General liability	**$167,876**	$180,037	$180,267
Commercial and personal umbrella	**66,281**	64,730	59,847
Commercial transportation	**49,119**	48,285	51,707
Specialty program business	**29,362**	25,507	38,289
Executive products	**12,029**	13,040	9,807
Other	**18,735**	16,618	18,976
Total	**$343,402**	$348,217	$358,893
PROPERTY			
Commercial property	**$ 92,634**	$ 91,507	$ 66,410
Marine	**32,868**	16,785	3,286
Other property	**12,865**	14,289	10,832
Total	**$138,367**	$122,581	$ 80,528
SURETY	**$ 62,709**	$ 59,540	$ 51,886
Grand total	**$544,478**	$530,338	$491,307

Casualty

Casualty gross premiums written of $462.6 million were down 9 percent in 2007 following a decline of 2 percent in 2006 and virtually flat results in 2005. Only the personal umbrella and specialty program coverages experienced growth while all other lines were down by varying degrees as marketplace conditions for this segment continued to soften. General liability, our largest product in this segment, experienced a rate decline of 12 percent during 2007. General liability posted gross premiums written of $177.3 million, down 9 percent from 2006 and 13 percent from 2005. While rates have deteriorated, this coverage continued to sustain a good margin and profitable results. Transportation and executive products also sustained declines in gross premiums written in 2007, down 15 percent and 21 percent, respectively, due to continued rate and volume declines. Our personal umbrella coverage, which is less susceptible to softening market conditions, posted a 5 percent increase in gross premiums written in 2007. Despite competitive pressures in the casualty segment, we remained disciplined in writing only those accounts which we believe will provide adequate returns. The soft marketplace is likely to continue suppressing premium growth in 2008.

Underwriting income for the casualty segment was $101.9 million in 2007, compared to $68.4 million in 2006 and $72.0 million in 2005. These results translated into combined ratios of 70.3, 80.4 and 80.0, respectively for 2007, 2006, and 2005. Favorable development on prior accident years' loss reserves totaled $87.4 million, $40.0 million, and $57.5 million, respectively, for 2007, 2006, and 2005. This favorable emergence was concentrated on accident years 2002-2006, with the more recent years representing a larger portion of the release. In each of these years, actuarial studies indicated that cumulative experience attributable to some casualty coverages for mature accident years was considerably lower than the reserves booked, resulting in the release of reserves. The 2007 result was further impacted by a detailed analysis of recent favorable loss trends and reserve risk factors. This review resulted in certain refinements to our reserving methodologies. This and the increased stability in our business in the last few years diminished the needed level of carried reserves above the actuarial point estimate. Over half of the favorable prior years' loss development recorded in 2007 was the result of this detailed assessment and resulting reductions to our booked reserves.

From an insurance standpoint, the casualty segment has exposure to subprime market issues through our executive products' (directors and officers) coverages. We believe our exposure to subprime, however, is minimal. We have had a limited number of claims and expect our net exposure to subprime to be less than $5 million.

Property

Gross premiums written in the property segment declined 9 percent in 2007 after posting a 28 percent increase in 2006 and a 1 percent decline in 2005. The decline in 2007 was reflective of the softening marketplace for commercial property, impacted by a second consecutive year of benign hurricane activity. Softening rates for coastal wind-exposed risks, combined with increased competition for non-catastrophe exposed accounts, resulted in a reduction in premium writings. In addition, targeted reductions in our catastrophe exposure reduced property writings in 2007, as we continued to manage our exposure to catastrophic events (wind and earthquake). In 2006, we posted higher premiums, as the property segment saw significant premium increases through the first three quarters of the year, while our actual exposure to these events declined. Rates in catastrophe-prone areas, particularly those exposed to wind, were up markedly during this period. Wind rates softened toward the end of 2006. In 2005, we experienced a significant decline in our construction coverage, which we exited during the fourth quarter of that year. Earthquake coverage premiums had dropped in 2005 as we focused on reducing our exposure. On a positive note, our marine division that was launched in 2005 posted gross writings of $45.3 million in 2007, compared to $28.7 million in 2006 and $12.5 million in 2005.

Net premiums earned advanced for 2007 and 2006 as the significant growth in premium writings in commercial fire and marine during each of the preceding years was earned as revenue. In 2005, segment revenues decreased disproportionately as we incurred charges of approximately $10.0 million to meet minimum reinsurance premium requirements as well as to reinstate reinsurance coverage exhausted by loss activity on our construction coverage.

Underwriting income was $30.6 million in 2007, compared to income of $5.0 million in 2006 and a loss of $8.3 million in 2005. Results for 2007 were impacted by a benign hurricane season, a decline in losses from tornadoes and hail storms, as well as lower frequency and severity of commercial fire losses. Additionally, unlike the previous two years, the segment's results for 2007 were not adversely affected by losses on discontinued construction coverages. In 2006, although we experienced a light hurricane season, other catastrophe losses such as tornadoes and hailstorms, along with increased severity of commercial fire losses, served to hamper the segment's income. Favorable loss reserve development from the two prior years' hurricane reserves contributed $4.2 million to profits in 2006. However, additional charges were incurred from the run-off of the previously exited construction coverage, which amounted to $13.7 million in 2006 compared to charges of $13.5 million in 2005. The 2005 results were also affected by the second straight year of severe hurricane activity, which negatively impacted the segment by $22.3 million.

Surety

Surety gross premiums written increased for the fourth straight year. With the exception of contract coverages, all major coverages in this segment produced increases in 2007. Net premiums earned followed suit, improving by 6 percent in 2007 compared to 15 percent and 9 percent in 2006 and 2005, respectively.

Underwriting income totaled $23.3 million in 2007, doubling for the second straight year. Underwriting income totaled $10.7 million in 2006, compared to $5.2 million in 2005. These results reflect the benefit of re-underwriting efforts initiated during 2003 and 2004, particularly with respect to contract surety coverages. In addition, underwriting income in 2007 included $11.1 million of favorable development on prior accident years' loss reserves. The majority of this development was the result of our actuary's risk reassessment and reflection of significantly lower reserve risk, following continued favorable loss trends and further progress on the Commercial Money Center litigation.

We are in litigation regarding certain commercial surety bond claims arising out of a specific bond program (the Commercial Money Center or "CMC" litigation). In the second quarter of 2007, we reached a confidential settlement agreement with Sky Bank, one of the investor banks involved in the litigation. In the third quarter of 2007, we reached a confidential settlement agreement with another investor bank, Ameriana Bank. These settlements ended our litigation with Sky Bank and Ameriana Bank but did not resolve our pending litigation with the remaining two investor banks (Bank of Waukegan and Atlantic Coast Federal, whose combined initial bond penal sum claims total approximately $9.3 million). The settlements with Sky Bank and Ameriana Bank related to surety bonds representing approximately 66 percent of the amount to which the five investor banks had claimed entitlement. As reported previously, in 2005, we reached a confidential settlement agreement with Lakeland Bank. In total, our settlement with the three investor banks noted above related to surety bonds representing approximately 83 percent of the amount to which the five investor banks had claimed entitlement. While we cannot predict the ultimate outcome of the pending litigation between us and the remaining two investor banks at this time, we continue to believe we have meritorious defenses with respect to each of the banks making claims against us and will continue to vigorously assert those defenses. We believe that we are adequately reserved for the ultimate outcome of the remaining litigation. See note 10 for further discussion.

The surety segment is another area that can have exposure to subprime. We write a few mortgage broker bonds, but believe this exposure to be minimal. In addition, we do not have significant exposure from a surety standpoint to the home building industry.

NET INVESTMENT INCOME AND REALIZED INVESTMENT GAINS

During 2007, net investment income increased by 11 percent due to asset allocation changes which resulted in an increased yield. On an after-tax basis, net investment income increased by 10 percent. The average annual yields on our investments were as follows for 2007, 2006, and 2005:

	2007	2006	2005
PRETAX YIELD			
Taxable (on book value)	**5.46%**	5.22%	4.90%
Tax-exempt (on book value)	**4.07%**	4.02%	3.98%
Equities (on fair value)	**3.03%**	2.78%	2.80%
AFTER-TAX YIELD			
Taxable (on book value)	**3.55%**	3.40%	3.19%
Tax-exempt (on book value)	**3.85%**	3.81%	3.77%
Equities (on fair value)	**2.60%**	2.39%	2.40%

The after-tax yield reflects the different tax rates applicable to each category of investment. Our taxable fixed income securities are subject to our corporate tax rate of 35 percent, our tax-exempt municipal securities are subject to a tax rate of 5.3 percent and our dividend income is generally subject to a tax rate of 14.2 percent. During 2007, the average after-tax yield on the fixed income portfolio increased to 3.7 percent from 3.6 percent in 2006 due to an increase in taxable and tax-exempt yields on new purchases. During the year, we focused on purchasing high-quality fixed-income investments, primarily in the 5-15 year range of the yield curve.

The fixed income portfolio increased by $16.5 million during the year. This portfolio had net realized losses of $1.0 million and a tax-adjusted total return on a mark-to-market basis of 6.4 percent. Our equity portfolio increased by $25.5 million during 2007, to $393.7 million. As of December 31, 2007, our consolidated equity portfolio had net unrealized gains of $138.1 million. The total return for the year on the equity portfolio was 4.8 percent.

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

(in thousands)

	Average Invested Assets[1]	Net Investment Income[2][3]	Net Realized Gains (Losses)[3]	Change in Unrealized Appreciation[3][4]	Annualized Return on Avg. Invested Assets	Tax Equivalent Annualized Return on Avg. Invested Assets
2003	1,166,694	44,151	12,138	40,096	8.3%	9.0%
2004	1,451,539	54,087	13,365	13,200	5.6%	6.3%
2005	1,633,755	61,641	16,354	(35,788)	2.6%	3.3%
2006	1,763,016	71,325	31,045	34,395	7.8%	8.6%
2007	**1,834,009**	**78,901**	**28,966**	**(14,650)**	**5.1%**	**5.9%**
5-yr Avg.	$1,569,803	$62,021	$20,374	$ 7,451	5.9%	6.6%

[1] Average amounts at beginning and end of year.
[2] Investment income, net of investment expenses.
[3] Before income taxes.
[4] Relates to available-for-sale fixed income and equity securities.

We realized $29.0 million in net investment gains in 2007. Included in this number is $29.9 million in net realized gains in the equity portfolio, $1.0 million in net realized losses in the fixed income portfolio, and other realized gains of $0.1 million. In 2006, we realized $31.0 million in net investment gains. We realized $22.4 million in net realized gains in the equity portfolio, $7.3 million in net realized losses in the fixed income portfolio, and other realized gains of $16.0 million. Included in other gains for 2006 was a $16.2 million gain from the sale of our equity in Taylor, Bean, & Whitaker Mortgage Corp. (TBW) as discussed in note 1 to the financial statements. In 2005, we realized net investment gains of $16.4 million. Included in this number are net realized gains of $15.9 million in the equity portfolio, net realized gains of $0.6 million in the fixed income portfolio, and other realized losses of $0.1 million. These realized gains and losses result from management decisions regarding relative valuation, fundamental analysis, and market conditions.

We regularly evaluate the quality of our investment portfolio. When we believe that a specific security has suffered an other-than-temporary decline in value, the investment's value is adjusted by reclassifying the decline from unrealized to realized losses. This has no impact on shareholders' equity. There have been no losses associated with the other-than-temporary impairment of securities in 2007, 2006, or 2005.

The following table is used as part of our impairment analysis and illustrates the total value of securities that were in an unrealized loss position as of December 31, 2007. This table segregates 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 table further classifies the securities based on the length of time they have been in an unrealized loss position.

(in thousands)	0-12 Mos.	>12 Mos.	Total
U.S. Government			
Fair value	$ 204	$ –	$ 204
Cost or amortized cost	204	–	204
Unrealized loss	**–**	**–**	**–**
U.S. Agency			
Fair value	$ –	$ 70	$ 70
Cost or amortized cost	–	70	70
Unrealized loss	**–**	**–**	**–**
Mtge/ABS/CMO*			
Fair value	$ 8,753	$ 89,604	$ 98,357
Cost or amortized cost	8,871	91,112	99,983
Unrealized loss	**(118)**	**(1,508)**	**(1,626)**
Corporate			
Fair value	$ 54,912	$ 65,971	$120,883
Cost or amortized cost	56,329	68,356	124,685
Unrealized loss	**(1,417)**	**(2,385)**	**(3,802)**
States, political subdivisions and revenues			
Fair value	$ 42,218	$ 46,605	$ 88,823
Cost or amortized cost	42.472	46,738	89,210
Unrealized loss	**(254)**	**(133)**	**(387)**
Subtotal, debt securities			
Fair value	$106,087	$202,250	$308,337
Cost or amortized cost	107,876	206,276	314,152
Unrealized loss	**(1,789)**	**(4,026)**	**(5,815)**
Common stock			
Fair value	$ 56,808	$ –	$ 56,808
Cost or amortized cost	64,604	–	64,604
Unrealized loss	**(7,796)**	–	**(7,796)**
Preferred stock			
Fair value	$ 29,436	$ –	$ 29,436
Cost or amortized cost	34,495	–	34,495
Unrealized loss	**(5,059)**	–	**(5,059)**
Total			
Fair value	$192,331	$202,250	$394,581
Cost or amortized cost	206,975	206,276	413,251
Unrealized loss	**(14,644)**	**(4,026)**	**(18,670)**

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

The following table is also used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of December 31, 2007, including fair value, cost basis, and unrealized gains and losses.

(in thousands)	Cost Basis	12/31/07 Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net	Unrealized Gain/ Loss%[1]
Consumer discretionary	$ 16,065	$ 17,812	$ 2,972	$(1,225)	$ 1,747	10.9%
Consumer staples	16,215	34,912	18,934	(237)	18,697	115.3%
Energy	8,447	33,424	24,977	–	24,977	295.7%
Financials	31,306	46,792	16,977	(1,491)	15,486	49.5%
Healthcare	15,787	28,255	13,167	(699)	12,468	79.0%
Industrials	16,986	41,880	24,894	–	24,894	146.6%
Materials	7,178	8,405	1,462	(235)	1,227	17.1%
Information technology	14,103	25,778	11,675	–	11,675	82.8%
Telecommunications	5,159	14,755	9,596	–	9,596	186.0%
Utilities	44,453	70,643	26,190	–	26,190	58.9%
Preferred stock	39,133	34,167	93	(5,059)	(4,966)	–12.7%
Mutual fund/ ETF	40,766	36,857	–	(3,909)	(3,909)	–9.6%
Total	**$255,598**	**$393,680**	**$150,937**	**$(12,855)**	**$138,082**	**54.0%**

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

In 2007, we added preferred stocks to our investment portfolio. The asset class offers attractive yield, risk and return characteristics that compliment our portfolio. However, the asset class is dominated by financial companies and, in 2007, had one of the worst return years in recent history. We maintain a high quality portfolio with all securities rated A or better.

As of December 31, 2007, we held 42 securities in our equity portfolio that were in unrealized loss positions. The total unrealized loss on these securities was $12.9 million. All of these securities have been in an unrealized loss position for less than 12 months, and no security has been in an unrealized loss of greater than 20% for more than six months.

The fixed income portfolio contained 181 positions at an unrealized loss as of December 31, 2007. Of these 181 securities, 100 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent $4.0 million in unrealized losses. The fixed income unrealized losses can be primarily attributed to changes in interest rates from the time of purchase. We continually monitor the credit quality of our fixed income investments to gauge our ability to be repaid principal and interest when contractually due. 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:

- credit ratings from major rating agencies, including Moody's and S&P,
- business and operating performance trends,
- management quality/turnover,
- industry competitive analysis, and
- changes in business model/strategy.

A timely topic in today's environment is subprime exposure. We define subprime mortgages as loans which include one or more of the following: a weak credit score (FICO score of less than 640), high debt-to-income ratio, high loan-to-value ratio, or undocumented income. We have reviewed our subprime investment exposure and believe our risk is minimal. We review our portfolio in three main areas to assess our subprime investment exposure — fixed income securities, common stocks and preferred stocks. Our exposure to subprime is through direct investments in subprime backed mortgage products and is less than $10 million. All of these securities are rated AAA and have been paying as agreed. These securities are fixed rate, exclude interest rate resets, were issued prior to 2005, and are not currently on watch from any major rating agency.

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 fixed income portfolios, we do not believe any securities suffered an other-than-temporary decline in value as of December 31, 2007.

MORTGAGE-BACKED, COMMERCIAL MORTGAGE-BACKED, AND ASSET-BACKED SECURITIES

Our mortgage-backed securities (MBS) portfolio is comprised of residential MBS investments. As of December 31, 2007, MBS investments totaled $196.7 million (14 percent) of the carrying value of the fixed income portfolio compared to $147.7 million (11 percent) as of December 31, 2006.

We believe MBS investments add diversification, liquidity, credit quality and additional yield to our portfolio. Our objective for the MBS portfolio is to provide reasonable cash flow stability and increased yield. The MBS portfolio includes collateralized mortgage obligations (CMOs), and mortgage-backed pass-through securities. A mortgage pass thru is a security consisting of a pool of residential mortgage loans. All payments of principal and interest are passed through to investors each month. A CMO is a mortgage-backed security with a fixed maturity. This can eliminate the risks associated with prepayment because each security is divided into maturity classes that are paid off in order. Our MBS portfolio generally does not include interest-only securities, principal-only securities or other MBS investments which may exhibit extreme market volatility.

Prepayment/extension risk is an inherent risk of holding MBSs. However, the degree of prepayment/extension risk varies by the type of MBS held. We reduce our portfolio's exposure to prepayment/extension by including less volatile types of MBSs. As of December 31, 2007, $32.1 million (16 percent) of the carrying value of the MBS portfolio was invested in planned amortization class CMOs (PACs) compared to $29.4 million (20 percent) as of December 31, 2006. PACs are securities whose cash flows are designed to remain constant in a variety of mortgage prepayment environments. Most of the portfolio's non-PAC MBSs possess varying degrees of cash flow structure and prepayment/extension risk. The MBS portfolio contained 82 percent of pure pass-throughs as of December 31, 2007 compared to 78 percent as of December 31, 2006. As of December 31, 2007, all of the securities in our MBS portfolio were rated AAA. In addition, 100 percent of these securities were mortgage-backed securities issued by the Governmental National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC). Government Sponsored Enterprises (GSEs), such as GNMA, FNMA and FHLMC, facilitate liquidity in the mortgage market by purchasing conforming mortgages from lenders, securitizing them and selling them into the secondary market.

The following table summarizes the distribution by investment type of our MBS portfolio as of the dates indicated:

MBS

(in thousands)	Amortized Cost	Estimated Fair Value	% of Total
2007			
Planned amortization class	**$32,407**	**$ 32,103**	**16%**
Sequential	**2,967**	**3,002**	**2%**
Pass-throughs	**160,542**	**161,580**	**82%**
Total	**$195,916**	**$196,685**	**100%**
2006			
Planned amortization class	$ 30,065	$ 29,389	20%
Sequential	2,960	2,934	2%
Pass-throughs	116,645	115,397	78%
Total	**$149,670**	**$147,720**	**100%**

Our asset-backed securities (ABS) portfolio includes home equity and credit card-backed investments, among others. As of December 31, 2007, ABS/CMBS (commercial mortgage-backed securities) investments were $98.6 million (7 percent) of the carrying value of the fixed income portfolio, compared to $112.2 million (8 percent) as of December 31, 2006. CMBS made up $63.4 million (64 percent) of the ABS/CMBS portfolio compared to $75.8 million (67 percent) at December 31, 2006. All of the CMBS portfolio was rated AAA as of December 31, 2007.

We believe that ABS/CMBS investments add diversification and additional yield to our portfolio. Like the MBS portfolio, the objective for the ABS/CMBS portfolio is to provide reasonable cash flow stability and attractive yield. Our ABS/CMBS portfolio generally does not include interest-only securities, principal-only securities or other ABS/CMBS investments which may exhibit extreme market volatility.

The following table summarizes the distribution by investment type of our ABS/CMBS portfolio as of the dates indicated:

ABS/CMBS

(in thousands)	Amortized Cost	Estimated Fair Value	% of Total
2007			
CMBS	**$63,209**	**$63,352**	**64%**
Home equity	**9,709**	**9,628**	**10%**
Auto	**1,000**	**1,012**	**1%**
Equipment	**3,468**	**3,486**	**3%**
Franchise	**3,000**	**2,961**	**3%**
Utility	**14,344**	**14,664**	**15%**
Credit Card	**3,479**	**3,486**	**4%**
Total	**$98,209**	**$98,589**	**100%**
2006			
CMBS	$76,176	$75,787	67%
Home equity	12,032	11,914	11%
Auto	7,441	7,465	7%
Equipment	3,437	3,437	3%
Franchise	–	–	0%
Utility	11,961	12,075	11%
Credit Card	1,515	1,515	1%
Total	**$112,562**	**$112,193**	**100%**

When making investments in MBS/ABS/CMBS, we evaluate the quality of the underlying collateral, the structure of the transaction (which dictates how losses in the underlying collateral will be distributed) and prepayment risks.

Recent market activity has put pressure on securities containing subprime exposure. As previously stated, all of our investments in securities that contain subprime collateral are rated AAA. In addition, all of the securities containing subprime collateral were originated before 2005.

The following table summarizes the distribution by collateral classification and rating of our subprime securities as of December 31, 2007 and 2006:

SUBPRIME

(in thousands)	Rating	Amortized Cost	Estimated Fair Value	% of Total
2007				
Home Equity	**AAA**	**$9,709**	**$9,628**	**100%**
Total		**$9,709**	**$9,628**	**100%**
2006				
Home Equity	AAA	$12,032	$11,914	100%
Total		**$12,032**	**$11,914**	**100%**

Municipal Fixed Income Securities

As a highly profitable insurance company, we have a significant allocation to municipal fixed income securities. As of December 31, 2007, approximately 25 percent of our investment portfolio was allocated to municipal securities. Of our consolidated municipal fixed income portfolio, approximately 70 percent is insured by what we consider traditional monoline insurers through wrap insurance. Given the recent headline risk associated with the municipal bond insurers, and the historically low default rates of municipal fixed income securities, we would prefer buying municipal securities without this wrap insurance. However, this is a difficult task in a marketplace dominated by insured issuance.

We believe municipal fixed income securities provide diversification, liquidity, credit quality and additional yield to our portfolio. Our objective for the municipal fixed income portfolio is to provide reasonable cash flow stability and increased after tax yield.

Our municipal fixed income portfolio is comprised of general obligation (GO) and revenue securities. The revenue sources include but are not limited to public improvement, school, transportation, colleges and universities, water and sewer.

As of December 31, 2007, approximately 48 percent of the municipal fixed income securities in the investment portfolio were GO and the remaining 52 percent were revenue fixed income.

When factoring in the insurance wrap, 87 percent of our municipal fixed income securities are rated AAA.

In addition, the underlying credit on all our municipal fixed income securities without the wrap insurance is A rated or better, with an average credit quality of AA. We believe our municipal fixed income portfolio has very high credit quality and do not believe the insurance is necessary to own these securities. Most importantly, the underlying credit strength of the municipalities that issued the securities has not changed.

The amortized cost and estimated fair value of fixed income securities at December 31, 2007, by contractual maturity, are shown as follows:

(in thousands)	Amortized Cost	Estimated Fair Value
Total fixed income		
Due in one year or less	$ 27,136	$ 27,277
Due after one year through five years	307,737	312,488
Due after five years through 10 years	581,162	586,102
Due after 10 years	447,697	448,524
Total	**$1,363,732**	**$1,374,391**

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

INTEREST AND GENERAL CORPORATE EXPENSE

Interest on debt in 2007 and 2005 reflected higher outstanding short-term debt obligations. In 2006, we paid down our short-term debt during the year. We incur short-term debt through the use of reverse repurchase transactions. 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. Decisions regarding future short-term debt management will be based on available cash flow and the interest rate environment.

In 2007, 2006, and 2005, we incurred $6.0 million in interest on our long-term debt. Our long-term debt consists of $100.0 million in senior notes that mature on January 15, 2014, and pay interest semi-annually at the rate of 5.95 percent.

General corporate expenses tend to fluctuate relative to our executive compensation plan and have increased in each of the last three years due to strong operating results. Our compensation model measures comprehensive earnings against a minimum required return on our capital. Bonuses are earned as we generate earnings in excess of this required return. In each of the last three years, we have generated earnings significantly above the required return, resulting in increased bonuses earned. Additionally, director fees and travel rose in each of the last three years. Legal expense increased in 2006 and 2005, but declined in 2007, due to the settlement of certain anti-trust litigation. The settlement was reached in May 2007, resulting in a full release from the lawsuit without payment of any damages or settlement fees.

INVESTEE EARNINGS

We maintain a 40 percent equity interest in Maui Jim, a manufacturer of high-quality polarized sunglasses. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim. In 2007, we recorded $7.3 million in earnings from this investment compared to $8.8 million in 2006 and $8.4 million in 2005. While sunglass sales advanced 15 percent in 2007, costs associated with expansion efforts and the discontinuance of certain sunglass styles resulted in a decline in earnings. In 2007, Maui Jim invested heavily in new sales and distribution offices (nationally and internationally), a new state-of-the-art Rx lab for presecription sunglasses, as well as new display programs and duty free and corporate gift channels across the world. In addition, the company recorded higher-than-normal expense associated with the discontinuance of some slow-moving styles and the replacement of temples on a specific product line.

Also included in investee earnings in 2006 and 2005 were $6.3 million and $2.5 million, respectively, from our investment in TBW. In the fourth quarter of 2006, we sold our equity in TBW for $32.5 million, resulting in a pretax realized gain of $16.2 million.

INCOME TAXES

Our effective tax rates were 30.9 percent, 28.0 percent, and 25.5 percent for 2007, 2006, and 2005, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2007 was higher than 2006 and 2005 due to the increase in underwriting income and net realized gains, which were taxed at 35.0 percent. Partially offsetting tax expense in 2007 was a $2.4 million tax benefit recorded in the third quarter to reflect the benefit expected to be realized upon the future payment of certain accrued compensation. Results for 2006 include the favorable resolution of a tax examination. During 2006, the Internal Revenue Service concluded an examination of our tax years 2000 through 2004. As a result of this exam, we recorded a $3.2 million tax benefit, resulting from a change in tax estimate related to the sale of assets. In 2006 and 2005, a tax benefit was realized associated with a dividend declared and paid in 2007 and 2006, respectively, from our unconsolidated investee, Maui Jim. As required under Statement of Financial Accounting Standards (SFAS) 109, "Accounting for Income Taxes," the tax benefit results from applying the lower tax rate applicable to affiliated dividends (7 percent) as compared to the corporate capital gains tax rate (35 percent) on which previous tax estimates were based. In addition, our pretax earnings in 2007 included $29.8 million of investment income that is wholly or partially exempt from federal income tax, compared to $28.7 million and $28.2 million in 2006 and 2005, respectively.

NET UNPAID LOSSES AND SETTLEMENT EXPENSES

The primary liability on our balance sheet relates to unpaid losses and settlement expenses, which represents our estimated liability for losses and related settlement expenses before considering offsetting reinsurance balances recoverable. The largest asset on our balance sheet, outside of investments, is the reinsurance balances recoverable on unpaid losses and settlement expenses, which serves to offset this liability.

The liability can be further deconstructed into two parts: (1) case reserves representing estimates of losses and settlement expenses on known claims and (2) IBNR — incurred but not reported — reserves representing estimates of losses and settlement expenses on claims that have occurred but have not yet been reported to us. Our gross liability for both case and IBNR reserves is reduced by reinsurance balances recoverable on unpaid losses and settlement expenses to calculate our net reserve balance. This net reserve balance decreased from $793.1 million at December 31, 2006, to $774.9 million as of December 31, 2007. This reflects incurred losses of $190.9 million in 2007 offset by paid losses of $209.0 million, compared to incurred losses of $256.9 million offset by $202.4 million paid in 2006. The overall decrease in our net loss and loss adjustment expense reserves between 2007 and 2006 was due, in large part, to $105.2 million of favorable development on prior years' net loss reserves. This favorable development served to reduce net incurred losses, and thus net reserves. As previously discussed, over half of this favorable development was the result of the ground-up reserve risk assessment and subsequent refinements to our reserving methodologies and estimates that occurred in 2007.

Both the gross reserves (liability) and the reinsurance balances recoverable (asset) were reduced by the favorable reserve development. Total gross and ceded loss and loss adjustment expense reserves dropped from $1,318.8 million and $525.7 million, respectively, at December 31, 2006, to $1,192.2 million and $417.3 million, respectively, at December 31, 2007.

MARKET RISK DISCLOSURE

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

- monitoring the fair value of all financial assets on a constant basis,
- changing the character of future investment purchases as needed, and
- maintaining a balance between existing asset and liability portfolios.

INTEREST RATE RISK

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

Interest rate risk will also affect our income statement due to its impact on interest expense. As of December 31, 2007, our short-term debt obligations were $28.0 million. At the end of 2006, our short-term debt was zero. We also maintain a debt obligation that is long term in nature. Our long-term debt carries a fixed interest rate. As such, our interest expense on this obligation is not subject to changes in interest rates. As this debt is not due until 2014, we will not assume risk in our ability to refinance this debt for many years.

EQUITY PRICE RISK

Equity price risk is the potential that we will incur economic loss due to the decline of common stock prices. Beta analysis is used to measure the sensitivity of our equity portfolio to changes in the value of the S&P 500 Index (an index representative of the broad equity market). Our current equity portfolio has a beta of .77 in comparison to the S&P 500. Our equity investment returns have been similar to the S&P 500 with much less volatility. This low beta statistic reflects our long-term emphasis on maintaining a conservative, value oriented, dividend-driven investment philosophy for our equity portfolio.

SENSITIVITY ANALYSIS

The tables that follow detail information on the market risk exposure for our financial investments as of December 31, 2007. Listed on each table is the December 31, 2007, fair value for our assets and the expected pretax reduction in fair value given the stated hypothetical events. This sensitivity analysis assumes the composition of our assets remains constant over the period being measured and also assumes interest rate changes are reflected uniformly across the yield curve. For example, our ability to hold non-trading securities to maturity mitigates price fluctuation. For purposes of this disclosure, market-risk-sensitive instruments are divided into two categories: instruments held for trading purposes and those held for nontrading purposes. The examples given are not predictions of future market events, but rather illustrations of the effect such events may have on the fair value of our investment portfolio.

As of December 31, 2007, our fixed income portfolio had a fair value of $1.4 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2007, levels with all other variables held constant. Such scenarios would result in decreases in the fair value of the fixed income portfolio of $46.7 million and $98.8 million, respectively. Due to our use of the held-to-maturity designation for a portion of the fixed income portfolio, the balance sheet impact of these scenarios would be lower.

As of December 31, 2007, our equity portfolio had a fair value of $393.7 million. The base sensitivity analysis uses market scenarios of the S&P 500 Index declining both 10 percent and 20 percent. These scenarios would result in approximate decreases in the equity fair value of $30.7 million and $61.5 million, respectively. As we designate all equities as available-for-sale, these fair value declines would impact our balance sheet.

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

TABLE 1

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

(in thousands)	12/31/07 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	$ 15,413	$ (683)	$ –
Total trading	**15,413**	**(683)**	**–**
Held for nontrading purposes			
Fixed income securities	1,358,978	(46,061)	–
Equity securities	393,680	–	(30,746)
Total nontrading	**$1,752,658**	**(46,061)**	**(30,746)**
Total trading & nontrading	**$1,768,071**	**$(46,744)**	**$(30,746)**

TABLE 2

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

(in thousands)	12/31/07 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	$ 15,413	$ (1,384)	$ –
Total trading	**15,413**	**(1,384)**	**–**
Held for nontrading purposes			
Fixed income securities	1,358,978	(97,374)	–
Equity securities	393,680	–	(61,493)
Total nontrading	**$1,752,658**	**(97,374)**	**(61,493)**
Total trading & nontrading	**$1,768,071**	**$(98,758)**	**$(61,493)**

TABLE 3

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

(in thousands)	12/31/07 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	$ 15,413	$ 591	$ –
Total trading	**15,413**	**591**	**–**
Held for nontrading purposes			
Fixed income securities	1,358,978	41,775	–
Equity securities	393,680	–	30,746
Total nontrading	**$1,752,658**	**41,775**	**30,746**
Total trading & nontrading	**$1,768,071**	**$ 42,366**	**$ 30,746**

TABLE 4

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

(in thousands)	12/31/07 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	$ 15,413	$ 1,182	$ –
Total trading	**15,413**	**1,182**	**–**
Held for nontrading purposes			
Fixed income securities	1,358,978	84,582	–
Equity securities	393,680	–	61,493
Total nontrading	**$1,752,658**	**84,582**	**61,493**
Total trading & nontrading	**$1,768,071**	**$ 85,764**	**$ 61,493**

LIQUIDITY AND CAPITAL RESOURCES

OVERVIEW

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

(in thousands)	2007	2006	2005
Operating cash flows	$127,023	$171,775	$ 198,027
Investing cash flows (uses)	(6,718)	(63,325)	(152,907)
Financing cash flows (uses)	(120,305)	(108,450)	(45,120)

Our operating cash flow decreased in 2007 and 2006 compared to 2005. The 2007 decrease is primarily attributable to a reduction in premium volume and corresponding cash receipts while the decline in 2006 was reflective of increased paid losses on the prior years' hurricanes. The majority of the operating cash flow generated by the company in 2007 and 2006 was used in financing activities, funding the ongoing share repurchase program. As a result of the share repurchase activity in 2007 and 2006, less funds were allocated for use in investing activities.

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

We have entered into certain contractual obligations that require us to make recurring payments. The following table summarizes our contractual obligations as of December 31, 2007.

CONTRACTUAL OBLIGATIONS

		Payments due by period			
(in thousands)	Total	Less than 1 yr.	1-3 yrs.	3-5 yrs	More than 5 yrs.
Loss and settlement expense	$1,192,178	$316,359	$449,136	$204,274	$222,409
Long-term debt	100,000	–	–	–	100,000
Short-term debt	27,975	27,975	–	–	–
Capital lease	14	14	-	–	–
Operating leases	15,258	3,365	6,485	4,616	792
Total	**$1,335,425**	**$347,713**	**$455,621**	**$208,890**	**$323,201**

Loss and settlement expense reserves represent management's best estimate of the ultimate cost of settling reported and unreported claims and related expenses. As discussed previously, the estimation of loss and loss expense reserves is based on various complex and subjective judgments. Actual losses and settlement expenses paid may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements. Similarly, the timing for payment of our estimated losses is not fixed and is not determinable on an individual or aggregate basis. The assumptions used in estimating the payments due by periods are based on our historical claims payment experience. Due to the uncertainty inherent in the process of estimating the timing of such payments, there is a risk that the amounts paid in any period can be significantly different than the amounts disclosed above. Amounts disclosed above are gross of anticipated amounts recoverable from reinsurers. Reinsurance balances recoverable on unpaid loss and settlement reserves are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not discharge us of our liability to policyholders. Amounts recoverable from reinsurers on unpaid loss and settlement reserves totaled $417.3 million at December 31, 2007.

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

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

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

At December 31, 2007, we had short-term investments and other investments maturing within one year of approximately $100.9 million and investments of $412.2 million maturing within five years. We maintain revolving lines of credit with two financial institutions, each of which permits us to borrow up to an aggregate principal amount of $10.0 million. Under certain conditions, each of the lines may be increased up to an aggregate principal amount of $20.0 million. These facilities have three-year terms that expire on May 31, 2008. As of December 31, 2007, no amounts were outstanding on these facilities. We believe that cash generated by operations, cash generated by investments and cash available from financing activities will provide sufficient sources of liquidity to meet our anticipated needs over the next 12 to 24 months. We have generated positive operating cash flow for more than 20 consecutive years. In the most recent three years ended December 31, 2007, 2006, and 2005, our operating cash flow was $127.0 million, $171.8 million, and $198.0 million, respectively. The primary factor in our ability to generate positive operating cash flow is underwriting profitability. If we are not able to continue generating positive operating cash flow, we may have to sell investment securities, some of which might be sold at a loss.

OPERATING ACTIVITIES

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

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

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

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

INVESTING ACTIVITIES

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

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

We maintain a well-diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of December 31, 2007, our portfolio had a carrying value of $1.8 billion. Invested assets at December 31, 2007, increased by $11.5 million, or 1 percent, from December 31, 2006.

Our overall investment philosophy is designed to first protect policyholders by maintaining sufficient funds to meet corporate and policyholder obligations, then generate long-term growth in shareholders' equity. Because our existing and projected liabilities are sufficiently funded by the fixed income portfolio, we can improve returns by investing a portion of the surplus (within limits) in an equity portfolio. As of December 31, 2007, 51 percent of our shareholders' equity was invested in equities, as compared to 49 percent at December 31, 2006 and 46 percent at December 31, 2005.

We currently classify 5 percent of the securities in our fixed income portfolio as held-to-maturity, meaning they are carried at amortized cost and are intended to be held until their contractual maturity. Other portions of the fixed income portfolio are classified as available-for-sale (94 percent) or trading (1 percent) and are carried at fair value. As of December 31, 2007, we maintained $1.30 billion in fixed income securities within the available-for-sale and trading classifications. The available-for-sale portfolio provides an additional source of liquidity and can be used to address potential future changes in our asset/liability structure.

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

Our fixed income portfolio comprised 75 percent of our total 2007 portfolio, versus 74 percent of the total at December 31, 2006, and 78 percent of the total as of December 31, 2005. As of December 31, 2007, our fixed income portfolio contained 79 percent AAA-rated securities, 8 percent AA-rated securities, 9 percent A-rated securities, and 4 percent BBB-rated securities.

In selecting the maturity of securities in which we invest, we consider the relationship between the duration of our fixed income investments and the duration of our liabilities, including the expected ultimate payout patterns of our reserves. We believe that both liquidity and interest rate risk can be minimized by such asset/liability management. As of December 31, 2007, our fixed income portfolio's duration was 4.23 years and remained well diversified. During 2007, the total return on our bond portfolio on a tax-equivalent, mark-to-market basis was 6.4 percent.

In addition, at December 31, 2007, our equity portfolio had a value of $393.7 million, all of which is classified as available-for-sale and is also a source of liquidity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. The strategy remains one of value investing, with security selection taking precedence over market timing. A buy-and-hold strategy is used, minimizing both transactional costs and taxes. We maintain a well-diversified group of equity securities. During 2007, the total return on our equity portfolio on a mark-to-market basis was 4.8 percent.

FINANCING ACTIVITIES

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

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

Our capital structure is comprised of equity and debt obligations. As of December 31, 2007, our capital structure consisted of $100.0 million in 10-year maturity senior notes (long-term debt), $28.0

million in reverse repurchase agreements (short-term debt),and $774.4 million of shareholders' equity. Debt outstanding comprised 14 percent of total capital as of December 31, 2007.

Our 127th consecutive dividend payment was declared in the first quarter of 2008 and will be paid on April 15, 2008, in the amount of $0.23 per share. Since the inception of cash dividends in 1976, we have increased our annual dividend every year.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authorities of Illinois. The maximum dividend distribution is limited by Illinois law to the greater of 10 percent of RLI Insurance Company (RLI Ins.) policyholder surplus as of December 31 of the preceding year or the net income of RLI Ins. for the 12-month period ending December 31 of the preceding year. 2007 stand-alone net income for RLI Ins. was $126.2 million. Therefore, the maximum dividend distribution that can be paid by RLI Ins. during 2008 without prior approval is $126.2 million. 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. The limitation for 2007, based on the above criteria, was $75.7 million. In 2007, a total cash dividend of $149.7 million was paid by RLI Ins. A need existed to move additional capital to RLI Corp. from RLI Ins. to provide cash for the share repurchase plan, shareholder dividends, and interest on senior notes; therefore, permission for special dividends was sought and obtained from the Illinois Department of Insurance.

For the year, we repurchased 2,297,694 shares at an average cost of $58.00 per share ($133.3 million). The company has $85.7 million of remaining capacity from the $200 million repurchase program approved in 2007. We anticipate concluding this repurchase program in 2008.

OUTLOOK FOR 2008

The insurance marketplace, and in particular the excess and surplus lines segment, is subject to cycles involving alternating periods of price increases ("hard markets") and price decreases ("soft markets"). Pricing in the overall insurance marketplace has been on the decline for the past several years. We expect this trend to continue, although each of our insurance segments will likely be impacted by varying degrees. We expect to see premium growth in selected products in 2008 and underwriting income in all three of our insurance segments absent any major catastrophe. Specific details regarding events in our insurance segments follow.

CASUALTY

We expect the price softening seen in 2007 to continue in 2008. We will maintain our profit-focused strategy and look to broaden our production sources and product offerings as a means to holding our market position and potentially growing this segment. Rising profitability and rising levels of capital for the industry will serve to intensify competition for this segment. We look to our ability to exercise underwriting discipline and select quality risks to continue our profitability in 2008.

PROPERTY

The industry has taken advantage of recent quiet Atlantic hurricane seasons to rebuild capital depleted by hurricane events in 2005. We believe property pricing will continue to soften in the year ahead. Pricing actions continue to be tempered by greater rating agency focus on catastrophe claims-paying ability. We expect our marine business to grow moderately due to new product offerings and an increased focus on writing inland marine coverages. In addition, the recently launched facultative reinsurance product will be additive to premium in 2008. We expect the segment to produce underwriting income in 2008 absent any major catastrophes.

SURETY

The surety segment, like our other segments, is expected to feel the pressure of a softening marketplace. Our experienced underwriting staff coupled with our effective use of technology (IT platforms and decision support tools) point to continued profitability in 2008. We expect to see modest premium growth in this segment in 2008.

INVESTMENTS

Within our investment portfolio, we expect investment income to be relatively flat due to cash flow from operations funding a share repurchase program. At December 31, 2007, we have $85.7 million remaining on the authorized repurchase plan. In addition, reinvestment rates into fixed income securities may be less than previous rates. Twenty percent of our portfolio is invested in equity securities. We expect the dividend income on these securities to grow and the value of this portfolio will be dictated by the performance of the general stock market, which is difficult to predict.

PROSPECTIVE ACCOUNTING STANDARDS

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

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurement." SFAS 157 defines fair value and establishes a framework for measuring fair value in GAAP. The statement describes fair value as being based on a hypothetical transaction to sell an asset or transfer a liability at a specific measurement date, as considered from the perspective of a market participant who holds the asset or owes the liability. In addition, fair value should be viewed as a market-based measurement, not an entity-specific measurement. Therefore, fair value should be determined based on the assumptions that market participants would use in pricing an asset or liability, including all risks associated with that asset or liability.

SFAS 157 expands disclosures about the use of fair value to measure assets and liabilities, focusing on the inputs used to measure fair value and the effect of the measurements on earnings for the period. SFAS 157 does not change what assets and liabilities are currently recorded at fair value under existing GAAP but does add to the amount of detail disclosed on assets carried at fair value. SFAS 157 becomes effective for fiscal years beginning after November 15, 2007. We do not expect the implementation of SFAS 157 to have a significant impact on our financial position and results of operations.

SFAS NO. 159, "THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES" (SFAS 159)

In February 2007, FASB issued SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). SFAS 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. We did not elect early adoption. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. We are continuing to evaluate the provisions of this standard, in conjunction with our current investment mix and investment philosophy. We do not expect the implementation of SFAS 159 to have a significant impact on our financial position or results of operations.

EITF NO. 06-11, "ACCOUNTING FOR INCOME TAX BENEFITS OF DIVIDENDS ON SHARE-BASED PAYMENT AWARDS" (EITF 06-11)

In June 2007, the FASB ratified the consensus reached by the Emerging Issues Task Force (EITF) on the issue of "Accounting for Income Tax Benefits of Dividends on Share-based Payment Awards" (EITF 06-11). EITF 06-11 applies to share-based payment arrangements with dividend protection features that entitle employees to receive (a) dividends on equity-classified nonvested shares, (b) dividend equivalents on equity-classified nonvested share units, or (c) payments equal to the dividends paid on the underlying shares while an equity-classified share option is outstanding. EITF 06-11 also addresses when those dividends or dividend equivalents are charged to retained earnings under FASB 123(R) and result in an income tax deduction for the employer. EITF 06-11 requires that the realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity classified nonvested equity shares, nonvested equity share units, and outstanding equity share options are recognized as an increase to additional paid-in capital. EITF 06-11 should be applied prospectively to the income tax benefits that result from dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after December 15, 2007, and interim periods within those fiscal years.

Our share-based payments do not contain the dividend protection features discussed in this consensus. We do not pay dividends on nonvested or outstanding options. As a result, this consensus will have no impact on our financial position and results of operations.

STATE AND FEDERAL LEGISLATION

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

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

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

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

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

Many jurisdictions have laws and regulations that limit an insurer's ability to withdraw from a particular market. For example, states may limit an insurer's ability to cancel or not renew policies. Furthermore, certain states prohibit an insurer from withdrawing one or more lines of business from the state, except pursuant to a plan that is approved by the state insurance department. The state insurance department may disapprove a plan that may lead to marketplace disruption. Laws and regulations that limit cancellation and non-renewal and that subject program withdrawals to prior approval requirements may restrict our ability to exit unprofitable marketplaces. For example, the state of Florida passed legislation in early 2007 seeking to make residential homeowners' insurance in Florida more accessible and affordable by imposing regulatory changes and restrictions on many aspects of the insurance market in that state. The impact to us has been immaterial because we currently write a relatively small amount of residential homeowners' insurance in that state. We will continue to carefully monitor the legislative and regulatory activity in this area.

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

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

BROKER CONTINGENT COMMISSIONS

In 2004, the New York attorney general began an investigation into insurance broker and insurance company activities connected with contingent commission arrangements. The investigation led to lawsuits, both private suits and suits by state attorneys general, and prompted other attorneys general and state insurance departments to conduct further investigations. We have responded to all inquiries from state attorneys general and insurance departments, and have not been subject to any regulatory actions or paid any fees or fines as a result. We conducted an internal investigation of our contingent commission arrangements and related underwriting practices and found no improper actions. We have also established a corporate policy regarding the proper use and authorization of contingent commission agreements. The National Association of Insurance Commissioners (NAIC) has created a model act on these agreements for agents and brokers, and statutes have been proposed or enacted in several states. We continue to closely monitor all legislative developments.

TERRORISM INSURANCE

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

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

SARBANES-OXLEY ACT OF 2002

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

The annual certification of our CEO with respect to compliance with the New York Stock Exchange corporate governance listing standards has been submitted to the New York Stock Exchange and the annual certifications of our CEO and CFO required by the Sarbanes-Oxley Act of 2002 with respect to our 2007 fiscal year have been filed with the SEC as an exhibit to our annual report on Form 10-K for 2007.

ASBESTOS LITIGATION REFORM

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

FEDERAL REGULATION OF INSURANCE

The U.S. insurance industry is not currently subject to any significant amount of federal regulation, and instead is regulated principally at the state level. However, federal insurance legislation of various types is periodically proposed in Congress, and in 2007 several bills were introduced in Congress that would impact and regulate various aspects of the insurance industry. These proposed laws covered many areas, including amending and extending the current TRIA law, optional federal charter, streamlining state regulation of nonadmitted insurance, expanding the national flood insurance program, creating a national catastrophe insurance program, and ending the antitrust exemption for insurance companies. However, only the extension and amendment of the TRIA law was enacted, which is not expected to have a material impact on our company. We cannot predict whether one or more of the other proposed bills will again be proposed or enacted in 2008 or later, or the impact of any such enacted laws on our company. We will continue to monitor all significant federal insurance legislation.

CORPORATE COMPLIANCE

We have a code of conduct, corporate governance guidelines, and compliance manual, which provide directors, officers, and employees with guidance and requirements for complying with a variety of federal and state laws and company policies. Electronic versions of these documents, as well as the following documents, are, or will be, available on our web site (www.rlicorp.com): 2007 summary annual report; 2007 financial report; 2008 proxy statement; annual report on Form 10-K for 2007; and charters of the executive resources, audit, finance and investment, strategy, and nominating/corporate governance committees of the board of directors. Printed copies of these documents will be made available upon request without charge to any shareholder.

FORWARD LOOKING STATEMENTS

Forward looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 appear throughout this report. These statements relate to our current expectations, beliefs, intentions, goals or strategies regarding the future and are based on certain underlying assumptions by us. These forward looking statements generally include words such as "expect," "will," "should," "anticipate," "believe," and similar expressions. Such assumptions are, in turn, based on information available and internal estimates and analyses of general economic conditions, competitive factors, conditions specific to the property and casualty insurance industry, claims development, and the impact thereof on our loss reserves, the adequacy of our reinsurance programs, developments in the securities market and the impact on our investment portfolio, regulatory changes and conditions, and other factors. Actual results could differ materially from those expressed in, or implied by, these forward looking statements. We assume no obligation to update any such statements. You should review the various risks, uncertainties, and other factors listed from time to time in our Securities and Exchange Commission filings.