

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 difference in conditions coverages or oil and gas surety bonds. We also provide types of coverages not generally offered by other companies, such as our stand-alone personal umbrella policy. The excess and surplus market, which unlike the standard admitted market, is less regulated and more flexible in terms of policy forms and premium rates, provides an alternative 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 in all marketplaces, and we have achieved this for 13 consecutive years, averaging an 88.5 combined ratio over that period of time. This foundation 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, exchange traded funds (ETFs), and mutual funds. Private equity investments, primarily our minority ownership in Maui Jim, Inc. (Maui Jim), have also enhanced overall returns. We have a diversified investment portfolio 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, personal umbrella, transportation, executive products, commercial umbrella, multi-peril program business, 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 limiting the total policy limits written in a particular region, 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 bonds, including license and permit, notary, and court bonds. We also offer fidelity and crime coverage for commercial insureds and select financial institutions. 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 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 (generally accepted accounting principles 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 operating segment information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains/losses on investments, 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 and other-than-temporary impairment, recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes.

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, 2008, 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.

We do not reserve for natural or man-made catastrophes until an event has occurred. Shortly after such occurrence, we review insured locations exposed to the event, model loss estimates of the event based on our own exposures, and industry loss estimates of the event, and we consider our knowledge of frequency and severity from early claim reports to determine an appropriate reserve for the

catastrophe. These reserves are reviewed frequently based on loss reports and appropriate changes to our estimates are made to reflect any new information as it arises.

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

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

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 and through an internal peer review process.

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

Determination of Our Best Estimate

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

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

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

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

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

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

Loss reserve estimates are subject to a high degree of variability due to the inherent uncertainty of ultimate settlement values. Periodic adjustments to these estimates

will likely occur as the actual loss emergence reveals itself over time. We believe our loss reserving processes reflect industry best practices and our methodologies result in a reasonable provision for reserves as of December 31, 2008.

INVESTMENT VALUATION AND OTHER-THAN-TEMPORARY IMPAIRMENT

Throughout each year, we and our investment managers buy and sell securities to achieve investment objectives in accordance with investment policies established and monitored by our board of directors and executive officers.

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 using both quantitative and qualitative criteria to determine impairment losses for other-than-temporary declines in the fair value of the investments. The following are the factors for determining if a security is other-than-temporarily impaired:

- The length of time and the extent to which the fair value has been less than cost;
- The probability of significant adverse changes to the cash flows on a fixed income investment;
- The occurrence of a discrete credit event resulting in the issuer defaulting on a material obligation or the issuer is seeking protection from creditors under the bankruptcy laws, or the issuer is proposing a voluntary reorganization which creditors are asked to exchange their claims for cash or securities having a fair value substantially lower than par value of their claims; or
- The probability that we will not receive all contractual or estimated cash flows in the form of principal and interest.

Quantitative criteria considered during this process include, but are not limited to: the degree and duration of 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 and, for fixed maturities, whether the issuer is in compliance with terms and covenants of the security. Qualitative criteria include the credit quality, current economic conditions, the anticipated speed of cost recovery, the financial health of and specific prospects for the issuer, as well as our intent and ability to hold the security to maturity or until forecasted recovery. In addition, 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:

- changes in technology that may impair the earnings potential of the investment,
- the discontinuance of a segment of the business that may affect the future earnings potential,
- reduction or elimination of dividends,
- specific concerns related to the issuer's industry or geographic area of operation,
- significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
- downgrade in credit quality by a major rating agency.

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, Securities and Exchange Commission filings, A.M. Best and S&P rating developments, and insurance industry developments that may impact the financial condition of our reinsurers. In addition, we subject our reinsurance recoverables to detailed recoverable 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.

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.

DEFERRED TAXES

We record net deferred tax assets to the extent temporary differences representing future deductible items exceed future taxable items. A significant amount of our deferred tax assets relate to expected future tax deductions arising from claim reserves and future tax deductions related to changes in our investments' unrealized gain or loss positions.

Since there is no absolute assurance that these assets will be ultimately realized, management reviews our deferred tax positions to determine if it is more likely than not that the assets will be realized. Periodic reviews include, among other things, the nature and amount of the taxable income and expense items, the expected timing of when assets will be used or liabilities will be required to be reported and the reliability of historical profitability of businesses expected to provide future earnings. Furthermore, management considers tax-planning strategies it can use to increase the likelihood that the tax assets will be realized. If after conducting the periodic review, management determines that the realization of the tax asset does not meet the "more-likely-than-not" criteria, an offsetting valuation allowance is recorded, thereby reducing net earnings and the deferred tax asset in that period. In addition, management must make estimates of the tax rates expected to apply in the periods in which future taxable items are realized. Such estimates include determinations and judgments as to the expected manner in which certain temporary differences, including deferred amounts related to our equity method investment, will be recovered and thereby the applicable tax rates. These estimates are subject to change based on the circumstances.

On January 1, 2007, we adopted the provisions of FIN 48, "Accounting for Uncertainty in Income Taxes," which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." As it relates to uncertainties in income taxes, our unrecognized tax benefits, including interest and penalty accruals, are not

considered material to the consolidated financial statements and have not changed significantly upon the adoption of FIN 48. Also, no tax uncertainties are expected to result in significant increases or decreases to unrecognized tax benefits within the next 12-month period. Penalties and interest related to income tax uncertainties, should they occur, would be included in tax expense.

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

RESULTS OF OPERATIONS

Consolidated revenue, as displayed in the table that follows, totaled \$561.0 million for 2008, compared to \$652.3 million in 2007 and \$632.7 million in 2006.

CONSOLIDATED REVENUE (in thousands)	Year ended December 31,		
	2008	2007	2006
Net premiums earned	\$528,764	\$544,478	\$530,338
Net investment income	78,986	78,901	71,325
Net realized investment gains (losses)	(46,738)	28,966	31,045
Total consolidated revenue	\$561,012	\$652,345	\$632,708

Revenue declined in 2008 as premiums earned from insurance operations were down and the financial market turmoil resulted in realized losses on investment securities. Net premiums earned declined 3 percent in 2008, returning to a level similar to 2006. Casualty premium continued to decline due to overall rate softening and served to more than offset the increased premium writings our property and surety segments posted in the last three years and the subsequent earning of this premium as revenue. Despite a declining interest rate environment, investment income was flat compared to 2007, after posting a 10 percent increase in 2007. The result for 2007 was influenced by higher investment yields and an increased asset base over 2006. During 2008, we recorded \$46.7 million in net realized investment losses, primarily from other-than-temporarily impaired securities. Impairment charges were recorded on a high-yield municipal bond fund and securities in the financial sector, as the credit crisis and financial turmoil negatively impacted fixed income and equity values in the latter half of 2008. In 2007 and 2006, net realized gains contributed significantly to revenue. Results in 2007 included 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 were largely due to the sale of the equity in one of our investee holdings.

NET EARNINGS (in thousands)	2008	2007	2006
Underwriting income	\$ 83,063	\$155,765	\$ 84,056
Net investment income	78,986	78,901	71,325
Net realized investment gains (losses)	(46,738)	28,966	31,045
Debt interest	(6,704)	(6,997)	(6,581)
Corporate expenses	(6,853)	(9,474)	(8,069)
Investee earnings	4,844	7,315	15,117
Pretax earnings	\$106,598	\$254,476	\$186,893
Income tax	(27,922)	(78,609)	(52,254)
Net earnings	\$ 78,676	\$175,867	\$134,639

Net earnings declined in 2008 after two consecutive years of record earnings. The result for 2008 included \$24.0 million in hurricane losses and was negatively impacted by net realized investment losses. As discussed previously, in 2008, we recorded \$46.7 million in net realized investment losses, primarily from other-than-temporarily impaired securities.

Underwriting income remained positive at \$83.1 million, compared to \$155.8 million in 2007 and \$84.1 million in 2006. For each of these periods, the results were the product of disciplined underwriting in the current accident year, coupled with favorable development on prior accident years' reserves. In a soft market, as we have seen in the past several years, disciplined underwriting can result in a reduction in premium revenue. This discipline, however, can differentiate us from the broader market by ensuring more adequate pricing of both new and renewal business and serves to slow the pace of deterioration in underwriting results. Included in underwriting income for each of the last three years were the effects of favorable development on prior years' loss reserves. The more significant of these developments occurred in our casualty and surety segments, where loss trends have remained favorable. In 2008, we experienced \$55.7 million in favorable development on prior accident years' casualty and surety reserves, compared to favorable development for these segments of \$98.5 million in 2007 and \$41.6 million in 2006. Further discussion of reserve development can be found in note 6 to the financial statements.

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 attributable to the aforementioned favorable reserve developments totaled \$6.0 million, \$9.9 million, and \$3.5 million, respectively, for 2008, 2007 and 2006. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Partially offsetting the 2008 increase were reductions in bonus and profit-sharing earned due to hurricane losses and lower returns on capital. Hurricane losses resulted in a \$2.8 million reduction in bonus-related expenses. Realized and unrealized losses on investment

securities reduced our return on capital and resulted in reductions to and/or elimination of other bonus and profit-sharing expenses in 2008. In addition, we focused efforts on reducing non-acquisition/non-production expenses in 2008, which served to further reduce other insurance expenses.

Over the past several years, we have invested in our capacity to produce premium. We have expanded our geographic footprint of existing products by adding underwriters and entering new markets, and we have hired teams of underwriters to start new products. As a result, our policy acquisition costs, which include the expenses associated with this expansion, increased in 2008 and 2007. We believe this investment has positioned us well to capitalize on future market opportunities.

Investee earnings declined in 2008 and 2007. Investee results for 2008 were impacted by foreign exchange losses and the economic slowdown experienced during the last half of the year. The decline in 2007 was due in large part to the fourth quarter 2006 sale of the equity in one of our investee holdings.

Comprehensive loss for 2008 was \$1.9 million compared to comprehensive earnings of \$166.4 million in 2007 and \$157.0 million in 2006. Results for 2008 were negatively impacted by unrealized losses on equity and fixed income securities.

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 2008 and 2007. Increased competition and capacity in the marketplace have resulted in rate declines in our casualty and property segments. Our largest growth contributor in 2006, general liability, experienced a rate decline of 12 percent in 2008, following a similar rate decline in 2007. While rates have declined, this product continued to produce underwriting income. On the property side, in addition to a decline in rates, targeted reductions in our catastrophe exposure resulted in reduced writings in 2008 and 2007, as we continued to manage our exposure to catastrophic events. In 2008 and 2007, we posted moderate growth in our surety segment as we added underwriters and expanded geographically.

Our underwriting income and combined ratios are displayed in the tables below. Solid underwriting results for the casualty and surety segments were magnified by favorable development on prior accident years' loss reserves in each of the last three years. The property segment was impacted by hurricane losses in 2008, while 2007 and 2006 benefited from light hurricane seasons. Excluding hurricanes, loss frequency and severity declined in 2008 and 2007, particularly with respect to the discontinued construction

program and reduction in habitational fire exposures, both of which negatively impacted results for 2006. The following table and narrative provide a more detailed look at individual segment performance over the last three years.

GROSS PREMIUMS WRITTEN

(in thousands)	2008	2007	2006
Casualty	\$403,337	\$462,591	\$506,887
Property	200,794	206,041	225,610
Surety	77,038	70,702	66,516
Total	\$681,169	\$739,334	\$799,013

UNDERWRITING INCOME

(in thousands)	2008	2007	2006
Casualty	\$46,507	\$101,863	\$ 68,393
Property	15,813	30,569	4,988
Surety	20,743	23,333	10,675
Total	\$83,063	\$155,765	\$ 84,056

COMBINED RATIO

	2008	2007	2006
Casualty	85.2	70.3	80.4
Property	89.3	77.9	95.9
Surety	69.7	62.8	82.1
Total	84.2	71.4	84.1

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

(in thousands)	2008	2007	2006
CASUALTY			
General liability	\$140,891	\$167,876	\$180,037
Commercial and personal umbrella	65,091	66,281	64,730
Commercial transportation	46,710	49,119	48,285
Specialty program business	31,425	29,362	25,507
Executive products	13,846	12,029	13,040
Other	15,518	18,735	16,618
Total	\$313,481	\$343,402	\$348,217
PROPERTY			
Commercial property	\$ 85,271	\$ 92,634	\$ 91,507
Marine	48,166	32,868	16,785
Other property	13,426	12,865	14,289
Total	\$146,863	\$138,367	\$122,581
SURETY			
Grand total	\$ 68,420	\$ 62,709	\$ 59,540
Grand total	\$528,764	\$544,478	\$530,338

Casualty

Casualty gross premiums written of \$403.3 million were down 13 percent in 2008 following a decline of 9 percent in 2007 and 2 percent decline in 2006. Personal umbrella, executive products, and specialty program business experienced modest premium 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 in 2008, following rate declines of 12 percent in 2007 and 8 percent in 2006. General liability posted gross premiums written of \$140.0 million, down 21 percent from 2007 and 28 percent from 2006. While rates have deteriorated, this coverage continued to sustain a good margin and profitable results. Transportation and commercial umbrella also sustained declines in gross premiums written in 2008, down 15 percent each, due to continued rate and exposure declines. Our personal umbrella coverage posted a 3 percent increase in gross premiums written in 2008, after posting a 5 percent increase in 2007. Executive products posted a 4 percent increase in gross premiums written in 2008, as the marketplace for this product improved during the last quarter of the year. Increased submission activity and opportunities to write new business resulted in increased production in the last quarter of the year. Specialty program business posted a 1 percent increase in gross premiums as new production sources and product offerings served to offset declines in existing programs that were scaled back. 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 to challenge our ability to grow premium in this segment in 2009.

Underwriting income for the casualty segment was \$46.5 million in 2008, compared to \$101.9 million in 2007 and \$68.4 million in 2006. These results translated into combined ratios of 85.2, 70.3 and 80.4, respectively for 2008, 2007, and 2006. Favorable development on prior accident years' loss reserves totaled \$50.6 million, \$87.4 million, and \$40.0 million, respectively, for 2008, 2007, and 2006. This favorable emergence was concentrated in 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 more recent 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 the financial crisis and subprime market issues through our executive products' (directors and officers) coverages. As financial institutions have not been a segment of focus for our executive products' coverages, we believe our exposure to the financial crisis is limited. In addition, we believe our exposure to subprime is also minimal.

Property

Gross premiums written in the property segment declined 3 percent in 2008 after posting a decline of 9 percent in 2007 and an increase of 28 percent in 2006. The decline in 2008 and 2007 was reflective of the softening marketplace for commercial property, impacted by two years (2006 and 2007) of benign hurricane activity. While the market experienced hurricane losses in 2008, we have not seen a significant increase in rates as capacity remains available. Softening rates for coastal wind-exposed risks, combined with increased competition for non-catastrophe exposed accounts, resulted in a reduction in premium writings in 2008 and 2007. In addition, targeted reductions in our catastrophe exposure to earthquake reduced property writings. Earthquake coverage premiums have dropped in each of the last three years as we focused on reducing our exposure. While still providing an adequate return, wind rates softened toward the end of 2006 and have remained soft through 2008. On a positive note, our marine division that was launched in 2005 posted gross writings of \$61.4 million in 2008, compared to \$45.3 million in 2007 and \$28.7 million in 2006. In addition, facultative reinsurance added \$4.8 million during 2008 in gross premiums written in its first full year of production.

Net premiums earned for the property segment advanced for each of the last three years. Net premiums earned for 2008 benefited from decreased catastrophe reinsurance costs and a reduction in facultative reinsurance purchased. We have increased our retention in select areas. The marine division, a growth product over the last three years, represented a larger percentage of segment premiums and has increased retentions. Increased retention results in a higher level of risk of loss. Net premiums earned in 2007 and 2006 advanced as the significant growth in premium writings in commercial fire and marine during each of the preceding years was earned as revenue.

Underwriting income was \$15.8 million in 2008, compared to income of \$30.6 million in 2007 and \$5.0 million in 2006. Results for 2008 include \$22.8 million in losses associated with Hurricanes Gustav and Ike, which more than offset the improved loss performance of non-wind

commercial fire accounts. Results for 2007 benefited from 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 2006, the segment's results for 2008 and 2007 were not adversely affected by losses on discontinued construction coverages. In fact, results for 2008 include favorable development on prior years' construction reserves as losses developed better than anticipated. For 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 prior years' hurricane reserves contributed \$4.2 million to income 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.

Surety

Surety gross premiums written increased in each of the last three years, as all coverages in this segment produced increases in 2008. Net premiums earned followed suit, improving by 9 percent in 2008, 6 percent in 2007 and 15 percent in 2006. Investment in capacity, through underwriter additions and geographic expansion, fueled premium growth in mature coverages. In addition, we established a new fidelity division in late 2008 focusing on fidelity and crime coverage for commercial insureds and select financial institutions. While these investments resulted in increased acquisition costs, loss ratios remained low resulting in positive underwriting income.

Underwriting income totaled \$20.7 million in 2008, compared to \$23.3 million in 2007 and \$10.7 million in 2006. After doubling for two consecutive years, underwriting income declined modestly in 2008, but represented excellent results for this segment. Premium growth was achieved while maintaining underwriting discipline. Positive results on the current accident year were amplified by favorable development on prior accident years. In 2008, favorable development on prior accident years' loss reserves totaled \$5.1 million, compared to \$11.1 million in 2007 and \$1.6 million in 2006. The majority of development in 2008 was from the 2007 accident year, as loss trends continued to be favorable. For 2007, the majority of the favorable 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.

As discussed more fully in note 10, we have been in litigation regarding certain commercial surety bond claims arising out of a specific bond program (the Commercial Money Center or "CMC" litigation). During 2008, we

reached confidential settlements with the two remaining banks. With these two settlements, we have now reached settlements with each of the five investor banks that had claimed entitlement under the surety bonds issued. We were adequately reserved for these settlements. See note 10 for further discussion.

The surety segment is another area that can have exposure to the financial crisis and subprime market issues. The financial turmoil resulted in a slight increase in claim frequency on miscellaneous and energy bonds during the last quarter of the year. As for subprime market issues, we write only a few mortgage broker bonds and 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 2008, net investment income was flat. The average annual yields on our investments were as follows for 2008, 2007, and 2006:

	2008	2007	2006
PRETAX YIELD			
Taxable (on book value)	5.58%	5.46%	5.22%
Tax-exempt (on book value)	3.99%	4.07%	4.02%
Equities (on fair value)	3.81%	3.03%	2.78%
AFTER-TAX YIELD			
Taxable (on book value)	3.63%	3.55%	3.40%
Tax-exempt (on book value)	3.78%	3.85%	3.81%
Equities (on fair value)	3.27%	2.60%	2.39%

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 2008, the average after-tax yield on the fixed income portfolio remained at 3.7 percent, the same yield as 2007. 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 decreased by \$98.3 million during the year. This portfolio had net realized losses of \$8.2 million and a tax-adjusted total return on a mark-to-market basis of 2.5 percent. Our equity portfolio decreased by \$106.9 million during 2008, to \$286.8 million. As of December 31, 2008, our equity portfolio had net unrealized gains of \$35.5 million. The total return for the year on the equity portfolio was -31.1 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
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%
2008	1,749,303	78,986	(46,738)	(123,607)	-5.2%	-4.5%
5-yr Avg.	\$1,686,324	\$68,988	\$8,598	\$(25,290)	3.2%	3.9%

⁽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 \$46.7 million in net investment losses in 2008. Included in this number is \$38.7 million in net realized losses in the equity portfolio, \$8.2 million in net realized losses in the fixed income portfolio, and other realized gains of \$0.2 million. In 2007, we realized \$29.0 million in net investment gains. We realized \$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 net investment gains of \$31.0 million. Included in this number are net realized gains of \$22.4 million in the equity portfolio, net realized losses of \$7.3 million 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.

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. During 2008, we recognized other-than-temporary impairment losses of \$76.2 million. This total includes \$64.2 million in equity and \$12.0 million in fixed income securities. The majority of the losses came during the third and fourth quarters as the markets were impacted by the slowing economy and global financial crisis. The majority of our other-than-temporary impairment losses were related to securities in the financial sector and a high-yield municipal bond mutual fund. The impaired securities were negatively impacted by the overall financial crisis and lack of liquidity in the credit markets. There were no losses associated with the other-than-temporary impairment of securities in 2007 or 2006.

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, 2008. 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	\$ —	\$ —	\$ —
Cost or amortized cost	—	—	—
Unrealized loss	—	—	—
U.S. Agency			
Fair value	\$ 34,955	\$ —	\$ 34,955
Cost or amortized cost	35,379	—	35,379
Unrealized loss	(424)	—	(424)
Mtge/ABS/CMO*			
Fair value	\$ 38,551	\$ 16,721	\$ 55,272
Cost or amortized cost	41,769	19,495	61,264
Unrealized loss	(3,218)	(2,774)	(5,992)
Corporate			
Fair value	\$135,865	\$32,737	\$168,602
Cost or amortized cost	149,935	38,707	188,642
Unrealized loss	(14,070)	(5,970)	(20,040)
States, political subdivisions and revenues			
Fair value	\$133,515	\$13,250	\$146,765
Cost or amortized cost	137,660	13,970	151,630
Unrealized loss	(4,145)	(720)	(4,865)
Subtotal, debt securities			
Fair value	\$342,886	\$62,708	\$405,594
Cost or amortized cost	364,743	72,172	436,915
Unrealized loss	(21,857)	(9,464)	(31,321)
Common stock			
Fair value	\$ 83,406	\$ 11,912	\$ 95,318
Cost or amortized cost	106,540	16,076	122,616
Unrealized loss	(23,134)	(4,164)	(27,298)
Preferred stock			
Fair value	\$ 2,613	\$ —	\$ 2,613
Cost or amortized cost	2,871	—	2,871
Unrealized loss	(258)	—	(258)
Total			
Fair value	\$428,905	\$74,620	\$503,525
Cost or amortized cost	474,154	88,248	562,402
Unrealized loss	(45,249)	(13,628)	(58,877)

*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, 2008, including fair value, cost basis, and unrealized gains and losses.

(in thousands)	Cost Basis	12/31/08 Fair Value	Net Unrealized Gains/Losses		Net	Unrealized Gain/Loss% ⁽¹⁾
Common stock:						
Consumer discretionary	\$ 18,265	\$ 14,700	\$ 102	\$ (3,667)	\$ (3,565)	-19.5%
Consumer staples	11,492	22,113	10,621	—	10,621	92.4%
Energy	11,171	22,181	11,792	(782)	11,010	98.6%
Financials	17,549	20,406	4,134	(1,277)	2,857	16.3%
Healthcare	10,395	18,439	9,073	(1,029)	8,044	77.4%
Industrials	15,560	19,249	5,121	(1,432)	3,689	23.7%
Information technology	13,005	14,807	4,333	(2,531)	1,802	13.9%
Materials	4,329	3,284	—	(1,045)	(1,045)	-24.1%
REITs	4,771	4,833	86	(24)	62	1.3%
Telecommunications	4,408	8,950	4,542	—	4,542	103.0%
Utilities	41,980	52,495	12,581	(2,066)	10,515	25.0%
ETFs	53,556	40,111	—	(13,445)	(13,445)	-25.1%
High-yield muni fund	33,341	33,341	—	—	—	—
Preferred stock	11,461	11,881	678	(258)	420	3.7%
Total	\$251,283	\$286,790	\$63,063	\$(27,556)	\$ 35,507	14.1%

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

As of December 31, 2008, we held 37 securities in our equity portfolio that were in unrealized loss positions. The total unrealized loss on these securities was \$27.6 million. In considering both the significance and duration of the unrealized loss positions, we have no equity securities in an unrealized loss of greater than 20 percent for more than six months.

The fixed income portfolio contained 229 positions at an unrealized loss as of December 31, 2008. Of these 229 securities, 33 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent \$9.5 million in unrealized losses. The fixed income unrealized losses can be primarily attributed to spreads widening in the corporate, municipal and mortgage backed security markets. We have the ability and intent to hold these securities to maturity. In addition, we continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. We consider price declines of securities in our other-than-temporary impairment analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

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

- changes in technology that may impair the earnings potential of the investment,
- the discontinuance of a segment of the business that may affect the future earnings potential,
- reduction or elimination of dividends,
- specific concerns related to the issuer's industry or geographic area of operation,
- significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
- downgrade in credit quality by a major rating agency.

Based on our analysis, we've concluded that the remaining securities are not other-than-temporarily impaired.

INVESTMENTS

We maintain a diversified investment portfolio which has had an 80 percent fixed income and 20 percent equity target over the last five years. As of December 31, 2008, the portfolio had a fair value of \$1.7 billion, down from \$1.8 billion at the end of 2007. The decline in the value of the investment portfolio was the result of the severe downturn in the global financial markets and economy. Our continuing focus is to manage our risks and to position the portfolio to take advantage of market opportunities while minimizing declines in the portfolio.

As of December 31, 2008, our investment portfolio had the following asset allocation breakdown:

PORTFOLIO ALLOCATION

(in thousands)	Cost or Amortized Cost	Fair Value	Unrealized Gain/(Loss)	% of Total Fair Value	Quality
Agencies	\$ 294,897	\$ 298,093	\$ 3,196	18.0%	AAA
Corporates	290,492	272,886	(17,606)	16.4%	A
Mortgage-backed	217,778	216,196	(1,582)	13.0%	AAA
Asset-backed	21,594	21,206	(388)	1.3%	AAA
Treasuries	12,662	13,396	734	0.8%	AAA
Munis	449,356	453,879	4,523	27.3%	AA
Total fixed income	\$1,286,779	\$1,275,656	\$(11,123)	76.8%	AA
Equities	\$ 206,481	\$ 241,568	\$ 35,087	14.6%	
High-yield muni fund	33,341	33,341	—	2.0%	
Total equity	\$ 239,822	\$ 274,909	\$ 35,087	16.6%	
Preferred stock	\$11,461	\$ 11,881	\$420	0.7%	
Short-term investments	\$ 97,982	\$ 97,982	—	5.9%	
Total portfolio	\$1,636,044	\$1,660,428	\$ 24,384	100.0%	

Quality in the above table and in all subsequent tables is an average of each bond's credit rating, adjusted for its relative weighting in the portfolio.

Our fixed income portfolio comprised 77 percent of our total 2008 portfolio, versus 75 percent of the total at December 31, 2007, and 74 percent of the total as of December 31, 2006. As of December 31, 2008, the carrying value of our fixed income portfolio consisted of 48 percent AAA-rated securities, 23 percent AA-rated securities, 22 percent A-rated securities, and 7 percent BBB-rated or lower 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, 2008, our fixed income portfolio's duration was 4.4 years and remained diversified. During 2008, the total return on our bond portfolio on a tax-equivalent, mark-to-market basis was 2.5 percent.

In addition, at December 31, 2008, our equity portfolio had a value of \$286.8 million, all of which is classified

as available-for-sale and is also a source of liquidity. We maintain a diversified group of equity securities. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. In addition, we have investments in real estate investment trusts, exchange traded funds, preferred stocks, and a high-yield municipal bond fund. 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. During 2008, the total return on our equity portfolio on a mark-to-market basis was -31.1 percent, compared to the S&P return of -37.0 percent.

Our investment portfolio does not have any direct exposure to credit default swaps or derivatives. As of December 31, 2008, \$15.4 million of our bond portfolio was part of a securities lending program. We have suspended the securities lending program and expect to be out of the program by the end of next year.

FIXED INCOME PORTFOLIO

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

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

Our fixed income portfolio remained diversified with investments in treasury, government sponsored agency, corporate, municipal, mortgage backed, and asset backed securities. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities and we believe it is probable that we will receive all contractual or estimated cash flows based on our analysis of previously disclosed factors.

We have two securities that are rated BB or below. The first security, a Lehman Bros. corporate bond, has a fair value of \$5,700 and is held in our trading portfolio. We are currently not receiving any interest payments for this security. The second security, a Wrigley Co. corporate bond, has a fair value of \$3.0 million and is currently not rated. The Wrigley Co. was purchased by a private company, Mars, Inc., in 2008. We believe it is probable that we will receive all contractual payments from this security.

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, 2008, MBS investments totaled \$172.6 million (14 percent) of the fixed income portfolio compared to \$205.7 million (15 percent) as of December 31, 2007.

We believe MBS investments add diversification, liquidity, credit quality and additional yield to our portfolio. Our objective for the MBS portfolio is to provide reasonable cash flow stability and increased yield. This sector experienced

unusually high volatility given the concerns over housing prices and general economic conditions. The MBS portfolio includes collateralized mortgage obligations (CMOs) and mortgage-backed pass-through securities. A mortgage pass-through is a security consisting of a pool of residential mortgage loans. All payments of principal and interest are passed through to investors each month. A CMO is a mortgage-backed security with a fixed maturity. This can eliminate the risks associated with prepayment because each security is divided into maturity classes that are paid off in order. Our MBS portfolio does not include interest-only securities, principal-only securities or other MBS investments which may exhibit extreme market volatility.

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, 2008, \$0.6 million of the MBS portfolio was invested in planned amortization class CMOs (PACs) compared to \$32.2 million (16 percent) as of December 31, 2007. 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 78 percent of pure pass-throughs as of December 31, 2008, compared to 81 percent as of December 31, 2007. As of December 31, 2008, virtually all of the securities in our MBS portfolio were rated AAA. In addition, 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. This market was further strengthened in the fourth quarter as a result of several federal Treasury policies including buying mortgages in the open market.

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

MBS				
(in thousands)	Rating	Amortized Cost	Fair Value	% of Total
2008				
Planned amortization class	AAA	\$ 62	\$ 62	0%
Sequential	AAA	37,846	38,538	22%
Pass-throughs	AAA	130,343	133,962	78%
Total		\$168,251	\$172,562	100%
2007				
Planned amortization class	AAA	\$ 32,481	\$ 32,180	16%
Sequential	AAA	5,964	5,987	3%
Pass-throughs	AAA	166,463	167,520	81%
Total		\$204,908	\$205,687	100%

An asset-backed security (ABS) is a type of debt security that is based on pools of assets or collateralized by the cash flows from a specific pool of underlying assets. These asset pools can include items such as credit card payments, auto loans and mortgages. The majority of our ABS portfolio is comprised of rate reduction utility bonds. As of December 31, 2008, ABS/CMBS (commercial mortgage-backed securities) investments were \$64.8 million (5 percent) of the fixed income portfolio, compared to \$97.7 million (7 percent) as of December 31, 2007. CMBS made up \$43.6 million (67 percent) of the ABS/CMBS portfolio compared to \$61.5 million (63 percent) at December 31, 2007. The entire CMBS portfolio was rated AAA as of December 31, 2008.

We 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 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)	Rating	Amortized Cost	Fair Value	% of Total
2008				
CMBS	AAA	\$49,527	\$43,635	67%
Home equity	AAA	2,702	2,529	4%
Auto	AAA	3,903	3,799	6%
Equipment	AAA	1,768	1,774	3%
Franchise	AAA	—	—	—
Utility	AAA	12,860	12,765	19%
Credit card	AAA	361	339	1%
Total		\$71,121	\$64,841	100%
2007				
CMBS	AAA	\$61,333	\$61,493	63%
Home equity	AAA	9,716	9,629	10%
Auto	AAA	5,000	5,024	5%
Equipment	AAA	3,460	3,486	4%
Franchise	AAA	3,000	2,960	3%
Utility	AAA	14,350	14,664	15%
Credit card	AAA	409	408	0%
Total	AAA	\$97,268	\$97,664	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 many collateralized securities. In general, as credit becomes more difficult to obtain, interest rate spreads on collateralized securities widen. As stated previously, the vast majority of our MBS/ABS/CMBS portfolio is rated AAA.

The following table summarizes the distribution by collateral classification and rating of our subprime securities as of December 31, 2008 and 2007:

SUBPRIME				
(in thousands)	Rating	Amortized Cost	Fair Value	% of Total
2008				
Home equity	AAA	\$2,702	\$2,529	100%
Total		\$2,702	\$2,529	100%
2007				
Home equity	AAA	\$9,716	\$9,629	100%
Total		\$9,716	\$9,629	100%

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 \$3 million. Of this amount, all securities are rated AAA and have been paying as agreed. All of these are fixed rate, exclude interest rate resets, were issued prior to 2005, and are not currently on watch from any major rating agency.

Municipal Fixed Income Securities

We have a significant allocation to municipal fixed income securities. As of December 31, 2008, municipal bonds totaled \$453.9 million (36 percent) of our fixed income portfolio as compared to \$473.7 million (34 percent) as of December 31, 2007.

We believe municipal fixed income securities provide diversification, high 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 sectors such as sewer and water, public improvement, school, transportation, colleges and universities, water and sewer.

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

The amortized cost and fair value of fixed income securities at December 31, 2008, by contractual maturity, are shown as follows:

(in thousands)	Amortized Cost	Fair Value
Total fixed income		
Due in one year or less	\$ 28,430	\$ 28,725
Due after one year through five years	280,630	284,994
Due after five years through 10 years	447,920	439,101
Due after 10 years	529,799	522,836
Total	\$1,286,779	\$1,275,656

Corporate Debt Securities

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

The following table illustrates our corporate debt exposure to the financial and non-financial sectors as of December 31, 2008, including fair value, cost basis, and unrealized gains and losses:

(in thousands)	Amortized Cost	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
Bonds:				
Corporate - financial	\$ 84,267	\$ 78,396	\$ 110	\$ (5,981)
All other corporate	183,509	175,859	2,600	(10,250)
Financials - private placements	12,026	9,513	-	(2,513)
All other corporate - private placements	10,690	9,118	-	(1,572)
	\$290,492	\$272,886	\$2,710	\$(20,316)

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

EQUITY SECURITIES

As of December 31, 2008, our equity portfolio totaled \$286.8 million (17 percent) of the investment portfolio compared to \$393.7 million (21 percent) as of December 31, 2007. The securities within the equity portfolio remain primarily invested in large-cap issues with a focus on dividend income. In addition, we have investments in real estate investment trusts, exchange traded funds, preferred stocks, and a high-yield municipal bond fund. In 2008, we recorded impairment losses of \$64.2 million on our equity securities. The impairments were the result of our belief that the securities were not likely to recover in a reasonable period of time.

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

(in thousands)	Cost Basis	12/31/2008 Fair Value	% of Total Fair Value	Net Unrealized Gain/Loss
Common stock:				
Consumer discretionary	\$ 18,265	\$ 14,700	5.1%	\$ (3,565)
Consumer staples	11,492	22,113	7.7%	10,621
Energy	11,171	22,181	7.7%	11,010
Financials	17,549	20,406	7.1%	2,857
Healthcare	10,395	18,439	6.4%	8,044
Industrials	15,560	19,249	6.7%	3,689
Information technology	13,005	14,807	5.2%	1,802
Materials	4,329	3,284	1.2%	(1,045)
REITs	4,771	4,833	1.7%	62
Telecommunications	4,408	8,950	3.1%	4,542
Utilities	41,980	52,495	18.3%	10,515
ETFs	53,556	40,111	14.0%	(13,445)
High-yield muni fund	33,341	33,341	11.6%	–
Preferred stock	11,461	11,881	4.2%	420
Total	\$251,283	\$286,790	100.0%	\$35,507

Common Stocks

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

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

Exchange Traded Fund Securities (ETFs)

ETFs are portfolios of stocks, bonds or, in some cases, other investments that trade on a stock exchange much the same as a regular stock.

All of our ETF holdings are stock portfolios that track to major indices. We believe this ETF strategy is a low cost, efficient vehicle enabling us to effectively participate in certain sectors of the market.

In 2008, we added two exchange traded funds to our equity portfolio. As of December 31, 2008, our ETF investment totaled \$40.1 million (14 percent) of the

equity portfolio compared to \$2.6 million (1 percent) as of December 31, 2007. The ETF investments add diversification, liquidity and increased return potential to our portfolio. In 2008, our ETFs outperformed the overall market but still contributed to the negative performance of the equity portfolio. We believe that ETF securities will be an important part of our investment program going forward. Our current ETFs contain large-cap securities that match our overall equity investment philosophy of providing superior dividend yields with less volatility than the market. These ETFs track various indices and have returns for 2008 consistent with the benchmark indices they follow.

High-Yield Municipal Bond Fund

As of December 31, 2008, our investment in the high-yield municipal bond fund totaled \$33.3 million (12 percent) of the equity portfolio compared to \$34.3 million (9 percent) as of December 31, 2007. While this mutual fund is comprised of fixed income securities, as a mutual fund we treat it as an equity. In 2008, we recorded impairment losses of \$18.6 million on the high-yield municipal bond fund due to our belief that the fund is unlikely to completely recover in value in a reasonable period of time and related changes in our intent to hold this security until recovery.

The holdings are comprised of lower quality investment grade and below investment grade tax-exempt securities. Sectors include healthcare, airports, tobacco, and infrastructure securities among others. The fund continues to make dividend payments and default rates of the bonds held in the fund remain below 1%. This market has been hurt by the flight to quality and overall liquidity in the municipal bond markets.

Preferred Stocks

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

In 2008, we recorded other-than-temporary impairment losses of \$26.4 million in our preferred stock portfolio based on our analysis of factors previously disclosed. In addition, we had related changes in our intent to hold these securities until recovery.

INTEREST AND GENERAL CORPORATE EXPENSE

Interest on debt declined in 2008 as we paid off our short-term debt. We incur short-term debt primarily 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. In 2007, we had expanded our use of this debt as yield spreads had widened. We paid off the reverse repurchase debt in 2008 as the credit markets experienced increased volatility. Decisions regarding future short-term debt management will be based on available cash flow and the interest rate environment.

In 2008, 2007, and 2006, we incurred \$6.0 million in interest on our long-term debt each year. 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. 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 2008, the actual return was below the required return resulting in no bonus earned on the current year and reductions to bonuses accrued but unpaid on prior years. In 2007 and 2006, we had generated earnings significantly above the required return, resulting in increased bonuses accrued.

INVESTE EARNINGS

We maintain a 40 percent equity interest in Maui Jim, Inc. (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 2008, we recorded \$4.8 million in earnings from this investment compared to \$7.3 million in 2007 and \$8.8 million in 2006. While sunglass sales advanced 7 percent in 2008 and 15 percent in 2007, costs associated with expansion efforts, foreign exchange losses, and the global economy affected earnings. In 2008, Maui Jim recorded over \$5 million in foreign exchange loss and was negatively affected by the global economic slowdown. In 2007 and 2006, Maui Jim had recorded foreign exchange gains of \$0.5 million and \$1.9 million, respectively. In 2007, Maui Jim invested heavily in new sales and distribution offices (nationally and internationally), a new state-of-the-art Rx lab for prescription 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.

In 2006, investee earnings included \$6.3 million 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 26.2 percent, 30.9 percent, and 28.0 percent for 2008, 2007, and 2006, respectively.

Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2008 was lower than 2007 and 2006 due to the decrease in underwriting income and the recognition of realized investment losses, which were taxed at 35.0 percent.

Our net earnings also include equity in earnings of an unconsolidated investee, Maui Jim. This investee does not have a pattern of paying dividends. As a result, we record a deferred tax liability on these earnings at the corporate capital gains rate of 35%. In recent periods, a tax benefit was realized associated with a dividend declared and subsequently received from 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 2008 included \$30.3 million of investment income that is partially exempt from federal income tax, compared to \$29.8 million and \$28.7 million in 2007 and 2006, respectively. 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.

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 increased to \$809.0 million at December 31, 2008, from \$774.9 million as of December 31, 2007. This reflects incurred losses of \$247.2 million in

2008 offset by paid losses of \$213.1 million, compared to incurred losses of \$190.9 million offset by \$209.0 million paid in 2007. The overall increase in our net loss and loss adjustment expense reserves between 2008 and 2007 was due to higher loss and loss adjustment expense ratios for the current accident year reflecting soft market conditions and a net loss from 2008 hurricanes of \$24.0 million which is still largely unpaid. In 2008, favorable loss development of \$62.3 million from prior years offset a portion of these increases.

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 to \$1,159.3 million and \$350.3 million, respectively, at December 31, 2008, from \$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, 2008, we had no short-term debt obligations. At the end of 2007, our short-term debt was \$28.0 million. 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 0.7 in comparison to the S&P 500. Our equity investment returns have been superior to the S&P 500 with less volatility. This low beta statistic reflects our long-term emphasis on maintaining a 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, 2008. Listed on each table is the December 31, 2008, 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 risks. For purposes of this disclosure, market-risk-sensitive instruments are divided into two categories: instruments held for trading purposes and those held for non-trading 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, 2008, our fixed income portfolio had a fair value of \$1.3 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2008, levels with all other variables held constant. Such scenarios would result in decreases in the fair value of the fixed income portfolio of \$41.1 million and \$88.4 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, 2008, our equity portfolio had a fair value of \$286.8 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 \$22.7 million and \$45.4 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)	12/31/08 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 10,020	\$ (282)	\$ –
Total trading	10,020	(282)	–
Held for nontrading purposes			
Fixed income securities	1,265,636	(40,836)	–
Equity securities	286,790	–	(22,715)
Total nontrading	1,552,426	(40,836)	(22,715)
Total trading & nontrading	\$1,562,446	\$(41,118)	\$(22,715)

TABLE 2

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

(in thousands)	12/31/08 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 10,020	\$ (648)	\$ –
Total trading	10,020	(648)	–
Held for nontrading purposes			
Fixed income securities	1,265,636	(87,747)	–
Equity securities	286,790	–	(45,429)
Total nontrading	1,552,426	(87,747)	(45,429)
Total trading & nontrading	\$1,562,446	\$(88,395)	\$(45,429)

TABLE 3

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

(in thousands)	12/31/08 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 10,020	\$ 340	\$ –
Total trading	10,020	340	–
Held for nontrading purposes			
Fixed income securities	1,265,636	37,591	–
Equity securities	286,790	–	22,715
Total nontrading	1,552,426	37,591	22,715
Total trading & nontrading	\$1,562,446	\$ 37,931	\$ 22,715

TABLE 4

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

(in thousands)	12/31/08 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 10,020	\$ 763	\$ –
Total trading	10,020	763	–
Held for nontrading purposes			
Fixed income securities	1,265,636	78,206	–
Equity securities	286,790	–	45,429
Total nontrading	1,552,426	78,206	45,429
Total trading & nontrading	\$1,562,446	\$ 78,969	\$ 45,429

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)	2008	2007	2006
Operating cash flows	\$161,334	\$127,023	\$171,775
Investing cash flows (uses)	(69,474)	(6,718)	(63,325)
Financing cash flows (uses)	(91,860)	(120,305)	(108,450)

We have posted strong operating cash flow in each of the last three years. Over the last ten years, our operating cash flow has averaged \$138.9 million per year. Variations in operating cash flow between periods are largely driven by premium volume, claim payments, reinsurance and taxes. In addition, fluctuations in insurance operating expenses impact operating cash flow. The reduction in premium volume experienced in 2008 and 2007 was partially offset by a decline in paid losses, relative to the level experienced in 2006. Loss payments were higher in 2006 as prior year hurricane claims were settled. In 2007, a higher level of pre-tax earnings resulted in significantly higher tax payments than were experienced in either 2008 or 2006. In each of the last three years, the majority of the operating cash flow generated was used in financing activities, funding the share repurchase program. During the last half of 2008, the share repurchase program was suspended and operating cash flow was allocated to 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, 2008.

CONTRACTUAL OBLIGATIONS

(in thousands)	Total	Payments due by period			
		Less than 1 yr.	1-3 yrs.	3-5 yrs	More than 5 yrs.
Loss and settlement expense	\$1,159,311	\$329,581	\$443,185	\$186,972	\$199,573
Long-term debt	132,725	5,950	11,900	11,900	102,975
Operating leases	12,948	3,676	5,901	3,275	96
Total	\$1,304,984	\$339,207	\$460,986	\$202,147	\$302,644

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 \$350.3 million at December 31, 2008.

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, 2008, we had short-term investments and other investments maturing within one year of approximately \$126.2 million and investments of \$409.8 million maturing within five years. We maintain a revolving line of credit with JP Morgan, which permits us to borrow up to an aggregate principal amount of \$25.0 million. Under certain conditions, the line may be increased up to an aggregate principal amount of \$50.0 million. The facility has a three-year term that expires on May 31, 2011. As of December 31, 2008, no amounts were outstanding on the revolving line of credit. 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, 2008, 2007, and 2006, our operating cash flow was \$161.3 million, \$127.0 million, and \$171.8 million, respectively. The primary factor in our ability to generate positive operating cash flow is underwriting profitability.

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
Proceeds from stocks sold	Purchase of stocks
Proceeds from sale of unconsolidated investee	

We maintain a 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, 2008, our portfolio had a carrying value of \$1.7 billion. Invested assets at December 31, 2008, decreased by \$180.9 million, or 10 percent, from December 31, 2007.

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, 2008, 41 percent of our shareholders' equity was invested in equities, as compared to 51 percent at December 31, 2007, and 49 percent at December 31, 2006.

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

The fixed income portfolio is structured to meet policyholder obligations and optimize the generation of after-tax investment income and total return objectives.

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, 2008, our capital structure consisted of \$100.0 million in 10-year maturity senior notes (long-term debt) and \$708.2 million of shareholders' equity. Debt outstanding comprised 12 percent of total capital as of December 31, 2008.

Our 131st consecutive dividend payment was declared in the first quarter of 2009 and will be paid on April 15, 2009, in the amount of \$0.26 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 in a rolling 12-month period 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. Therefore, the maximum dividend distribution that can be paid by RLI Ins. during 2009 without prior approval is \$67.8 million which represents 10 percent of policyholder surplus at December 31, 2008. The 12-month rolling dividend limitation in 2008, based on the above criteria, was \$126.2 million. In 2008, total cash dividends of \$70.0 million were paid by RLI Ins. These dividends were paid to provide additional capital to RLI Corp. and used for the share repurchase plan, shareholder dividends, interest on senior notes, and general corporate expenses.

For the year, we repurchased 917,200 shares at an average cost of \$52.23 per share (\$47.9 million). We have \$37.8 million of remaining capacity from the \$200 million stock repurchase program approved in 2007. In light of market volatility in the second half of 2008, the repurchase program was suspended in the third quarter of 2008 and will remain suspended until conditions warrant its reactivation.

OUTLOOK FOR 2009

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”). It is expected that deteriorating industry results, the “financial meltdown” of 2008 and the economic recession that intensified in late 2008 will begin to have a moderating impact on the soft market that has been in existence for the past several years.

We expect to see premium growth in selected products in 2009 and underwriting income overall, absent any major catastrophe. Specific details regarding events in our insurance segments follow.

CASUALTY

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 in this segment. We do expect to see soft market pricing beginning to moderate as the year unfolds.

Continued rate declines will make it increasingly difficult to post underwriting profits. However, we look to our ability to continue to exercise underwriting discipline, and select quality risks to outperform the marketplace in 2009.

PROPERTY

We believe property pricing will start to flatten in the year ahead. 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 2009. We expect the segment to produce underwriting income in 2009 absent any major catastrophes.

SURETY

The surety segment, like our other segments, is expected to feel the pressure of the stressed economic situation. In 2008, we expanded our geographic footprint and added fidelity coverages. We expect premium growth to continue in 2009. Our experienced underwriting staff coupled with our effective use of technology point to continued profitability in 2009.

INVESTMENTS

We anticipate further volatility in the capital markets in 2009. The underlying factors that drove equity prices higher including earnings growth, ease of credit, leverage, etc., are under pressure going into 2009. Because of this, we have allowed our equity allocations to drift below our 20 percent target. We would expect our allocation to remain below our target unless market conditions improve.

The low interest rate environment will put pressure on our investment income as cash flow is invested at lower yields.

Given the economic conditions of a recession, we believe maintaining a high quality, liquid portfolio in this environment is prudent.

PROSPECTIVE ACCOUNTING STANDARDS

There are several prospective accounting standards that we have not implemented either because the standard has not been finalized or the implementation date has not yet occurred. For a discussion of these prospective standards, see note 1 to the financial statements.

STATE AND FEDERAL LEGISLATION

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

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

Other regulations impose restrictions on the amount and type of investments our insurance company subsidiaries may have. Regulations designed to ensure financial solvency of insurers and to require fair and adequate treatment and service for policyholders are enforced by filing, reporting and examination requirements. Marketplace oversight is conducted by monitoring and periodically examining trade practices, approving policy forms, licensing of agents and brokers, and requiring the filing and in some cases, approval, of premiums and commission rates to ensure they are fair and equitable. Such restrictions may limit the ability of our insurance company subsidiaries to introduce new

coverages or implement desired changes to current premium rates or policy forms. Financial solvency is monitored by minimum reserve and capital requirements (including risk-based capital requirements), periodic reporting procedures (annually, quarterly, or more frequently if necessary), and periodic examinations.

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

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

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

Virtually all states require licensed insurers to participate in various forms of guaranty associations in order to bear a portion of the loss suffered by the policyholders of insurance companies that become insolvent. Depending upon state law, licensed insurers can be assessed an amount that is generally equal to a small percentage of the annual premiums written for the relevant lines of insurance in that state

to pay the claims of an insolvent insurer. These assessments may increase or decrease in the future, depending upon the rate of insolvencies of insurance companies. In some states, these assessments may be wholly or partially recovered through policy fees paid by insureds.

In addition, the insurance holding company laws require advance approval by state insurance commissioners of any change in control of an insurance company that is domiciled (or, in some cases, having such substantial business that it is deemed to be commercially domiciled) in that state. "Control" is generally presumed to exist through the ownership of 10 percent or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. In addition, insurance laws in many states contain provisions that require 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 a material delay of, or deter, any such transaction.

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

TROUBLED ASSET RELIEF PROGRAM

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

TERRORISM INSURANCE

After the events of September 11, 2001, the National Association of Insurance Commissioners (NAIC) urged states to grant conditional approval to commercial lines endorsements that excluded coverage for acts of terrorism consistent with language developed by the Insurance

Services Office, Inc. (ISO). The ISO endorsement included certain coverage limitations. Many states allowed the endorsements for commercial lines, but rejected such exclusions for personal exposures.

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

SARBANES-OXLEY ACT OF 2002

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

is intended to identify any deficiencies, measure their materiality, and implement procedures, where necessary, to remediate them.

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 2008 fiscal year have been filed with the SEC as an exhibit to our annual report on Form 10-K for 2008.

FEDERAL REGULATION OF INSURANCE

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

CORPORATE COMPLIANCE

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

FORWARD LOOKING STATEMENTS

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