

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. DESCRIPTION OF BUSINESS: We underwrite selected property and casualty insurance coverages.

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

B. PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION: The accompanying consolidated financial statements were prepared in conformity with GAAP (generally accepted accounting principles in the United States of America), which differ in some respects from those followed in reports to insurance regulatory authorities. The consolidated financial statements include the accounts of our holding company and our subsidiaries. All significant intercompany balances and transactions have been eliminated.

C. ADOPTED ACCOUNTING STANDARDS

SFAS No. 157, Fair Value Measurements (SFAS 157)

On January 1, 2008, we partially adopted Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." As allowed under Financial Accounting Standards Board (FASB) Staff Position (FSP) FAS 157-2, we have elected not to fully adopt SFAS 157 at this time and have deferred adoption for certain nonfinancial assets and liabilities. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and provides a hierarchical disclosure framework for assets and liabilities measured at fair value. The pronouncement describes fair value as being based on a hypothetical transaction to sell an asset or transfer a liability at a specific measurement date (an exit price), as considered from the perspective of a market participant who holds the asset or owes the liability. In addition, fair value should be viewed as a market-based measurement, not an entity-specific measurement. Therefore, fair value should be determined based on the assumptions that market participants would use in pricing an asset or liability, including all risks associated with that asset or liability, such as credit or liquidity risk. SFAS 157 became effective for fiscal years beginning after November 15, 2007. The

partial adoption of SFAS 157 had no impact on our financial position or results of operations.

FSP FAS 157-2, Effective Date of FASB Statement No. 157

FASB Staff Position (FSP) FAS 157-2 delays the effective date of FAS 157, Fair Value Measurements, to fiscal years beginning after November 15, 2008 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The delay is intended to allow the Board and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of FAS 157. Partial deferral of FAS 157 would apply to our goodwill.

FSP FAS 157-3, Determining the Fair Value of a Financial Asset when the Market for that Asset is not Active

FSP FAS 157-3 became effective on October 10, 2008 and clarifies the application of FASB Statement No. 157, "Fair Value Measurements," in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. In situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction that is not a forced liquidation or distressed sale. Determining the fair value of a financial asset in an illiquid market depends on the facts and circumstances and may require the use of significant judgments for certain Level 2 and all Level 3 financial assets where market activity is not readily available. As of December 31, 2008, we did not have any Level 3 financial assets which would require the use of significant judgments in the determination of fair value.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159)

On January 1, 2008, we adopted SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." The Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the board's long-term measurement objectives for accounting for financial instruments. SFAS 159 became effective for fiscal years beginning after November 15, 2007. We elected not to

implement the fair value option with respect to any existing assets or liabilities; therefore, the adoption of SFAS 159 had no impact on our financial position or results of operations.

D. PROSPECTIVE ACCOUNTING STANDARDS

SFAS No. 141(R), "Business Combinations" (SFAS 141(R))

In December 2007, the FASB issued SFAS 141(R), "Business Combinations," which replaces SFAS 141, "Business Combinations." Assets and liabilities that arose from business combinations which occurred prior to the adoption of SFAS 141(R) are not adjusted upon the adoption of SFAS 141(R). Among other things, SFAS 141(R) broadens the scope of SFAS 141 to include all transactions where an acquirer obtains control of one or more other businesses. SFAS 141(R) retains the guidance to recognize intangible assets separately from goodwill and requires, with limited exceptions, that all assets acquired and liabilities assumed, including certain contractual contingencies, be measured at their acquisition date fair values. SFAS 141(R) requires most acquisition and restructuring-related costs to be expensed as incurred. Step acquisitions, once control is acquired, are to be recorded at the full amounts of the fair values of the identifiable assets, liabilities and the non-controlling interest in the acquiree. SFAS 141(R) also replaces the reduction of asset values and recognition of negative goodwill with a requirement to recognize a gain in earnings. The provisions of SFAS 141(R) are effective for fiscal years beginning after December 15, 2008. Early adoption is not permitted. We will apply the provisions of SFAS No. 141(R) as applicable when effective.

FSP No. 142-3, "Determination of the Useful Life of Intangible Assets" (FSP 142-3)

In April 2008, the FASB issued FSP 142-3, "Determination of the Useful Life of Intangible Assets." FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under FASB 142, "Goodwill and Other Intangible Assets." The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other generally accepted accounting principles. This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Early adoption is prohibited. We do not expect the implementation of FSP 142-3 to have a significant impact on our financial position or results of operations.

FSP No. 140-4 and FIN 46(R)-8, "Disclosure by Public Entities (Enterprises) About Transfers of Financial Assets and Interests in Variable Interest Entities" (FSP 140-4 and FIN 46(R)-8)

In December 2008, the FASB issued FSP 140-4 and FIN 46R-8, "Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities." FSP 140-4 and FIN 46R-8 require additional disclosures about transfers of financial assets and involvement with variable interest entities. The requirements apply to transferors, sponsors, servicers, primary beneficiaries and holders of significant variable interests in a variable interest entity or qualifying special purpose entity. Disclosures required by FSP 140-4 and FIN 46R-8 are effective in the first quarter of fiscal 2009. Because FSP 140-4 and FIN 46R-8 only require additional disclosures, the adoption will not impact our financial position or results of operations.

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

Available-For-Sale Securities

Debt and equity securities not included as held-to-maturity or trading are classified as available-for-sale and reported at fair value. Our equity securities consist of a core stock portfolio weighted toward dividend-paying stocks, as well as preferred stock, real estate investment trusts (REITs), exchange traded funds (ETFs), and mutual funds. Unrealized gains and losses on these securities are excluded from net earnings but are recorded as a separate component of comprehensive earnings and shareholders' equity, net of deferred income taxes. All of our equity securities and approximately 94 percent of debt securities are classified as available-for-sale.

Held-to-Maturity Securities

Debt securities that we have the positive intent and ability to hold to maturity are classified as held-to-maturity and carried at amortized cost. Except for declines that are other-than-temporary, changes in the fair value of these securities are not reflected in the financial statements. We have classified approximately 3 percent of our debt securities portfolio as held-to-maturity.

Trading Securities

Debt and equity securities purchased for short-term resale are classified as trading securities. These securities are reported at fair value with unrealized gains and losses included in earnings. We have classified approximately 1 percent of our debt securities portfolio as trading. In 2008,

we inadvertently sold three fixed income positions (\$5.2 million) designated as held-to-maturity. From a custodial perspective, these securities were held with our available-for-sale portfolio. These transactions generated a realized gain of \$0.2 million. To mitigate the likelihood of this event reoccurring, we opened new custodial accounts to segregate our held-to-maturity investments from our available-for-sale investments.

For the years ended December 31, 2008, 2007, and 2006, no securities were transferred from held-to-maturity to available-for-sale or trading.

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. See note 2 for further discussion of other-than-temporary impairment.

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

losses on disposition of investments are based on specific identification of the investments sold on the trade date.

F. CASH: Cash consists of cash in banks, generally in operating accounts. On a daily basis, our cash accounts are swept into short-term investments, principally money market instruments. As a result, our balance sheet does not reflect any cash balance.

G. SHORT-TERM INVESTMENTS: We classify money market funds and securities lending collateral as short-term investments. Whereas our strategy is to be fully invested at all times, short-term investments in excess of demand deposit balances are considered a component of investment activities, and thus are classified as investments in our consolidated balance sheets. Short-term investments are carried at cost, which approximates fair value. These funds generally have original maturities of less than 90 days and, therefore, bear minimal risk. We have not experienced losses on these instruments.

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

We continuously monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements and Securities and Exchange Commission filings. We also review insurance industry developments that may impact the financial condition of our reinsurers. We analyze the credit risk associated with our reinsurance balances recoverable by monitoring the A.M. Best and Standard & Poor's (S&P) ratings 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.

I. 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.

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

K. INVESTMENT IN UNCONSOLIDATED INVESTEE: We maintain a 40 percent interest in the earnings of Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality polarized sunglasses, which is accounted for by the equity method. We also maintain a similar minority representation on their board of directors, held by our chairman, president, and CFO. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim, Inc. Our investment in Maui Jim was \$38.7 million in 2008 and \$38.2 million in 2007. In 2008, we recorded \$4.8 million in investee earnings compared to \$7.3 million in 2007 and \$8.8 million in 2006. Maui Jim recorded net income of \$11.6 million in 2008, \$18.0 million in 2007 and \$22.1 million in 2006. Additional summarized financial information for Maui Jim for 2008 and 2007 is outlined in the following table:

(in millions)	2008	2007
Total assets	\$141.3	\$150.3
Total liabilities	68.4	79.0
Total equity	72.9	71.3

Approximately \$26.0 million of undistributed earnings from Maui Jim are included in our retained earnings as of December 31, 2008. In 2008, we received a dividend of \$4.0 million from Maui Jim.

Prior to December 2006, we also maintained a 21 percent interest in the earnings of Taylor, Bean & Whitaker Mortgage Corp. (TBW), a private mortgage origination company which was accounted for by the equity method. In December 2006, we sold our interest in the company for \$32.5 million to TBW's chairman, who owned the majority of the outstanding shares prior to the sale. We realized a \$16.2 million pretax gain on the sale of equity. Our investment in TBW, prior to the sale, was \$16.3 million in 2006. In 2006, we recorded \$6.3 million in investee earnings.

In December 2006, we became a 17 percent participant in a loan syndicate which provided TBW's majority shareholder with short-term financing. Our share of the loan totaled \$5.0 million. The loan was collateralized by TBW shares and our portion contained the same market terms and conditions as those of the lead and other syndicate members. We also had a separate note receivable from TBW totaling \$4.5 million at December 31, 2006, which originated in 1999 as an operating loan. In 2007, we received payment in full for both the loan and note receivable from TBW.

We perform an impairment review of our investment in our unconsolidated investee which considers current valuation and operating results. Based upon the most recent review, this asset was not impaired.

L. INTANGIBLE ASSETS: In accordance with SFAS 142, "Goodwill and Other Intangible Assets," the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier when there is reason to suspect that their values may have been diminished or impaired. Goodwill, which relates to our surety segment, is listed separately on the balance sheet and totaled \$26.2 million at December 31, 2008 and 2007. Goodwill impairment testing was performed during 2008, pursuant to the requirements of SFAS 142. Based upon this review, this asset was not impaired.

Intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite-lived intangible assets that were amortized under SFAS 142 during the periods presented relate to our purchase of customer-related and marketing-related intangibles. These intangibles had useful lives ranging from five to 10 years. Amortization of intangible assets was \$0.1 million for 2007 compared to \$0.4 million for 2006. There was no amortization expense in 2008 as these assets were fully amortized in 2007.

At December 31, 2006, net intangible assets totaled \$0.1 million, net of \$5.6 million of accumulated amortization, and were included in other assets.

M. UNPAID LOSSES AND SETTLEMENT EXPENSES: The liability for unpaid losses and settlement expenses represents estimates of amounts needed to pay reported and unreported claims and related expenses. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social, and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves

are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. Due to the inherent uncertainty in estimating reserves for losses and settlement expenses, there can be no assurance that the ultimate liability will not exceed recorded amounts. If actual liabilities do exceed recorded amounts, there will be an adverse effect. Furthermore, we may determine that recorded reserves are more than adequate to cover expected losses, as happened during 2004 through 2008, when favorable experience primarily on casualty business led us to reduce our reserves. Based on the current assumptions used in estimating reserves, we believe that our overall reserve levels at December 31, 2008, make a reasonable provision to meet our future obligations. See note 6 for a further discussion of unpaid losses and settlement expenses.

N. INSURANCE REVENUE RECOGNITION: Insurance premiums are recognized ratably over the term of the contracts, net of ceded reinsurance. Unearned premiums are calculated on a monthly pro rata basis.

O. INCOME TAXES: We file a consolidated income tax return. Income taxes are accounted for using the asset and liability method under which deferred income taxes are recognized for the tax consequences of “temporary differences” by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities, operating losses, and tax credit carry forwards. The effect on deferred taxes for a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance if it is more-likely-than-not all or some of the deferred tax assets will not be realized.

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.” The adoption of FIN 48 did not have an impact on our financial position or results of operations as we have taken no significant tax positions which would require accrual or disclosure under the new guidance. Penalties and interest are included in tax expense. Although the IRS is not currently examining any of our income tax returns, tax years 2005 through 2008 remain open and are subject to examination.

P. EARNINGS PER SHARE: Pursuant to disclosure requirements contained in SFAS 128, “Earnings per Share,” the following represents a reconciliation of the numerator and denominator of the basic and diluted earnings per share (EPS) computations contained in the financial statements.

(in thousands, except per share data)	Income (Numerator)	Shares (Denominator)	Per Share Amount
For the year ended December 31, 2008			
Basic EPS			
Income available to common shareholders	\$ 78,676	21,540	\$3.65
Stock options	—	308	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$ 78,676	21,848	\$3.60
For the year ended December 31, 2007			
Basic EPS			
Income available to common shareholders	\$175,867	23,574	\$7.46
Stock options	—	511	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$175,867	24,085	\$7.30
(For the year ended December 31, 2006)			
Basic EPS			
Income available to common shareholders	\$134,639	24,918	\$5.40
Stock options	—	653	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$134,639	25,571	\$5.27

Q. COMPREHENSIVE EARNINGS: The difference between our net earnings and our comprehensive earnings is that comprehensive earnings include unrealized gains/losses on our available-for-sale investment securities net of tax, whereas net earnings does not include such amounts, and such amounts are instead directly credited or charged against shareholders’ equity. In reporting the components of comprehensive earnings on a net basis in the income statement, we have used a 35 percent tax rate. Other comprehensive income (loss), as shown in the consolidated statements of earnings and comprehensive earnings, is net of tax expense (benefit) of \$(43.3) million, \$(5.1) million and \$12.0 million, respectively, for 2008, 2007, and 2006.

R. FAIR VALUE DISCLOSURES: The following was considered in the estimation of fair value for each class of financial instruments for which it was practicable to estimate that value. We utilize Interactive Data Corporation (IDC) to

obtain quoted market prices for our investment securities. We continue to classify our equities as level 1 securities with “an active market.” All bonds are classified as level 2. Because these securities do not always have quoted market prices, other transactional data (prices of similar securities, prices of securities from the same issuer, spreads by issuer, sector, etc.) is used to arrive at the current market price. All but five of our 856 positions were priced through IDC at December 31, 2008. Two of the five positions that were not automatically priced used Bloomberg as the secondary pricing source, while the other three were priced by our custodian, JP Morgan. The total fair value of these five securities was less than \$13 million.

Fair value disclosures for investments are included in note 2. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, accounts payable, and short-term debt, their carrying amounts are reasonable estimates of fair value. The fair value of our long-term debt is discussed further in note 4.

S. STOCK-BASED COMPENSATION: We account for stock-based compensation pursuant to Statement of Financial Accounting Standards (SFAS) No. 123, “Share-Based Payment,” (SFAS 123R) which requires companies to expense the estimated fair value of employee stock options and similar awards. SFAS 123R requires entities to measure compensation cost for awards of equity instruments to employees based on the grant-date fair value of those awards and recognize compensation expense over the service period that the awards are expected to vest.

We calculate the tax effects of share-based compensation pursuant to SFAS 123(R) and under the alternative transition method provided in Financial Accounting Standards Board (“FASB”) Staff Position No. SFAS 123(R)-3, “Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards.” The alternative transition method included simplified methods to determine the impact on the additional paid-in capital pool (“APIC pool”) and consolidated statements of cash flows of the tax effects of employee share-based compensation awards that were outstanding upon adoption of SFAS 123(R).

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

T. RISKS AND UNCERTAINTIES: Certain risks and uncertainties are inherent to our day-to-day operations and to the process of preparing our financial statements. The more significant risks and uncertainties, as well as our attempt to mitigate, quantify, and minimize such risks, are presented below and throughout the notes to the consolidated financial statements.

Catastrophe Exposures

Our insurance coverages include exposure to catastrophic events. Our major catastrophe exposure is to losses

caused by earthquakes, primarily 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 monitor these exposures by quantifying our exposed policy limits in each region and by using computer-assisted modeling techniques. Additionally, we further limit our risk to such catastrophes through the purchase of reinsurance. In 2008, our property underwriting was supported by \$375 million in excess of a \$25 million first dollar retention in traditional catastrophe reinsurance protection, subject to certain retentions by us. The limit decreased to \$350 million at July 1, 2008. At January 1, 2009, we renewed our \$350 million reinsured limit, subject to certain retentions by us. We actively manage our catastrophe program to keep our net retention in line with risk tolerances and to optimize the risk/return trade off.

Environmental Exposures

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

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

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

Reinsurance

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

Investment Risk

Our investment portfolio is subject to market, credit, and interest rate risks. The equity portfolio will fluctuate with movements in the overall stock market. While the equity portfolio has been constructed to have lower downside risk than the market, the portfolio is sensitive to movements in the market. The bond portfolio is affected by interest rate changes and credit spreads. We mitigate our interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities.

The prolonged downturn of the global financial markets and economy resulted in significant declines and lack of liquidity in the financial markets. While we maintain a high quality portfolio, it was not immune to the negative swings in the markets. The deterioration was not limited in its scope, as most segments of the financial markets were impacted. As such, this resulted in our total portfolio having a negative return of 4.4 percent for the year. Continued downturns in the financial markets could have a negative effect on our portfolio. However, we manage this risk through asset allocation and security selection.

Liquidity Risk

Liquidity is essential to our business and a key component of our concept of asset-liability matching. Our liquidity may be impaired by an inability to collect premium receivable or reinsurance recoverable balances timely, an inability to sell assets or redeem our investments, an inability to access funds from our insurance subsidiaries, unforeseen outflows of cash or large claim payments, or an inability to access debt or equity capital markets. This situation may arise due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects third parties or us, or even by the perception among market participants that we, or other market participants, are experiencing greater liquidity risk. To date, the ongoing liquidity crisis and the loss of confidence in financial institutions has not increased our cost of funding and has not limited our access to some of our traditional sources of liquidity.

Our credit ratings are important to our liquidity. A reduction in our credit ratings could adversely affect our liquidity and competitive position, increase our borrowing costs, or limit our access to the capital markets.

Financial Statements

The preparation of the accompanying consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions about future events. These estimates and the underlying assumptions affect the amounts of assets and liabilities reported, disclosures about contingent assets and liabilities, and reported amounts of revenues and expenses. The

most significant of these amounts is the liability for unpaid losses and settlement expenses. Other estimates include investment valuation, the collectibility of reinsurance balances, recoverability of deferred tax assets, and deferred policy acquisition costs. These estimates and assumptions are based on management's best estimates and judgment. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, which management believes to be reasonable under the circumstances. We adjust such estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity markets have combined to increase the uncertainty inherent in such estimates and assumptions. Although recorded estimates are supported by actuarial computations and other supportive data, the estimates are ultimately based on our expectations of future events. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in those estimates resulting from continuing changes in the economic environment will be reflected in the financial statements in future periods.

External Factors

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

The National Association of Insurance Commissioners (NAIC) has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. We regularly monitor our subsidiaries' internal capital requirements and the NAIC's RBC developments. As of December 31, 2008, we have determined that our capital levels are well in excess of the minimum capital requirements for all RBC action levels and that our capital levels are sufficient to support the level of risk inherent in our operations.

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

2. INVESTMENTS

A summary of net investment income is as follows:

NET INVESTMENT INCOME

(in thousands)	2008	2007	2006
Interest on fixed income securities	\$68,290	\$69,481	\$64,486
Dividends on equity securities	13,863	12,252	10,402
Interest on short-term investments	1,484	2,716	2,125
Gross investment income	83,637	84,449	77,013
Less investment expenses	(4,651)	(5,548)	(5,688)
Net investment income	\$78,986	\$78,901	\$71,325

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

REALIZED/UNREALIZED GAINS

(in thousands)	2008	2007	2006
Net realized investment gains (losses)			
Fixed income			
Available-for-sale	\$ (8,350)	\$ (966)	\$ (7,351)
Held-to-maturity	270	89	92
Trading	(123)	(103)	(53)
Equity securities	(38,698)	29,863	22,374
Other	163	83	15,983
	(46,738)	28,966	31,045
Net changes in unrealized gains (losses) on investments			
Fixed income			
Available-for-sale	(21,032)	14,020	2,323
Held-to-maturity	(425)	(395)	(2,030)
Equity securities	(102,575)	(28,669)	32,072
	(124,032)	(15,044)	32,365
Net realized investment gains (losses) and changes in unrealized gains (losses) on investments	\$ (170,770)	\$13,922	\$63,410

During 2008, we recorded \$46.7 million in net realized losses and the portfolio experienced unrealized losses of \$124.0 million. For 2008, the net realized investment losses and changes in unrealized gains (losses) on investments totaled \$170.8 million. The majority of our net realized losses and change in unrealized gains were in our equity

portfolio. The equity portfolio was impacted by the negative return in the stock market, exposure to the financial sector with preferred stocks, and a flight to quality in the municipal bond market which negatively impacted our high-yield municipal bond mutual fund.

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

(in thousands)	Proceeds From Sales	Gross Realized Gains	Realized Losses	Net Realized Gain (Loss)
SALES				
2008 –				
Available-for-sale	\$143,074	\$ 4,269	\$ (3,759)	\$510
Held-to-maturity	5,230	179	–	179
Trading	10,885	241	(312)	(71)
Equities	89,032	25,959	(30,806)	(4,847)
2007 –				
Available-for-sale	\$ 99,360	\$ 452	\$ (1,435)	\$ (983)
Trading	6,619	25	(128)	(103)
Equities	77,040	32,347	(2,484)	29,863
2006 –				
Available-for-sale	\$231,385	\$ 666	\$ (8,076)	\$ (7,410)
Trading	4,950	17	(70)	(53)
Equities	146,635	41,097	(2,519)	22,374

CALLS/MATURITIES

2008 –				
Available-for-sale	\$327,462	\$137	\$ –	\$137
Held-to-maturity	28,870	92	(1)	91
Trading	1,561	1	–	1
2007 –				
Available-for-sale	\$199,427	\$ 38	\$(21)	\$ 17
Held-to-maturity	32,722	89	–	89
Trading	1,309	–	–	–
2006 –				
Available-for-sale	\$117,204	\$ 59	\$ –	\$ 59
Held-to-maturity	28,215	92	–	92
Trading	1,083	–	–	–

FAIR VALUE MEASUREMENTS

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

Effective January 1, 2008, we determined the fair values of certain financial instruments based on the fair value hierarchy established in SFAS 157. SFAS 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

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

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

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

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

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

Assets measured at fair value on a recurring basis as of December 31, 2008, are summarized below:

(in thousands)	Quoted in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Total
Trading securities	\$ —	\$ 10,020	—	\$ 10,020
Available-for-sale securities	286,790	1,224,215	—	1,511,005
Total	\$286,790	\$1,234,235	—	\$1,521,025

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

Assets and Liabilities Recorded at Fair Value on a Non-recurring Basis

As allowed under FSP FAS 157-2, Effective Date of FASB Statement No. 157, as of January 1, 2008, we have elected not to fully adopt SFAS 157 and have deferred adoption for certain nonfinancial assets and liabilities. On our balance sheet, this deferral would apply to goodwill.

In addition, the following is a schedule of amortized costs and estimated fair values of investments in fixed income and equity securities as of December 31, 2008 and 2007:

(in thousands)	Amortized Cost	Fair Value	Gross Unrealized Gains	Losses
2008				
AVAILABLE-FOR-SALE				
U.S. government	\$ 6,596	\$ 7,065	\$ 469	\$ —
U.S. agencies	285,937	288,177	2,664	(424)
Mtge/ABS/CMO*	233,275	231,522	4,239	(5,992)
Corporate	287,557	270,164	2,647	(20,040)
States, political subdivisions & revenues	423,311	427,287	8,841	(4,865)
Fixed maturities	1,236,676	1,224,215	18,860	(31,321)
Equity securities	251,283	286,790	63,063	(27,556)
Total available-for-sale	\$1,487,959	\$1,511,005	\$81,923	\$(58,877)
HELD-TO-MATURITY				
U.S. government	\$ 4,916	\$ 5,019	\$ 103	\$ —
U.S. agencies	8,960	9,916	956	—
States, political subdivisions & revenues	25,945	26,486	541	—
Total held-to-maturity	\$ 39,821	\$ 41,421	\$ 1,600	\$ —
TRADING**				
U.S. government	\$ 1,150	\$ 1,312	—	—
U.S. agencies	—	—	—	—
Mtge/ABS/CMO*	6,097	5,881	—	—
Corporate	2,935	2,722	—	—
States, political subdivisions & revenues	100	105	—	—
Total trading	\$ 10,282	\$ 10,020	—	—
Total	\$1,538,062	\$1,562,446	\$ 83,523	\$(58,877)

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

**Trading securities are carried at fair value with unrealized gains (losses) included in earnings.

(in thousands)	Amortized Cost	Fair Value	Gross Unrealized Gains	Losses
2007				
AVAILABLE-FOR-SALE				
U.S. government	\$ 6,656	\$ 6,788	\$ 132	\$ —
U.S. agencies	335,873	339,171	3,298	—
Mtge/ABS/CMO*	294,125	295,274	2,741	(1,592)
Corporate	229,587	228,183	2,299	(3,703)
States, political subdivisions & revenues	408,493	413,889	5,784	(388)
Fixed maturities	1,274,734	1,283,305	14,254	(5,683)
Equity securities	255,598	393,680	150,937	(12,855)
Total available-for-sale	\$1,530,332	\$1,676,985	\$165,191	\$(18,538)
HELD-TO-MATURITY				
U.S. government	\$ 6,250	\$ 6,382	\$ 132	\$ —
U.S. agencies	8,912	9,630	718	—
States, political subdivisions & revenues	58,486	59,661	1,175	—
Total held-to-maturity	\$ 73,648	\$ 75,673	\$ 2,025	\$ —
TRADING**				
U.S. government	\$ 2,150	\$ 2,221	—	—
U.S. agencies	1,066	1,087	—	—
Mtge/ABS/CMO*	8,051	8,077	—	—
Corporate	3,983	3,921	—	—
States, political subdivisions & revenues	100	107	—	—
Total trading	\$ 15,350	\$ 15,413	—	—
Total	\$1,619,330	\$1,768,071	\$167,216	\$(18,538)

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

**Trading securities are carried at fair value with unrealized gains (losses) included in earnings.

MBS/ABS/CMO

The unrealized losses in our MBS/ABS/CMO portfolio are primarily contained in the commercial mortgage-backed securities. These securities were negatively affected in the second half of the year by the overall decline in the real estate market and the lack of liquidity in the credit markets. The securities remain AAA rated and we believe it is probable that we will receive all contractual or estimated cash flows in the form of principal and interest. We have the ability and intent to hold these investments until recovery in value, which may be maturity, and thus do not consider these investments to be other-than-temporarily impaired at December 31, 2008.

Corporate Bonds

The unrealized losses in the corporate bond portfolio were caused by a general rise in interest rate spreads in 2008. The interest rate spread widening was primarily caused by the financial crisis and slowing economy. The corporate bond portfolio has an overall rating of A and we believe it is probable that we will receive all contractual payments in the form of principal and interest. In addition, we have the ability and intent to hold these investments until a recovery in value, which may be maturity. We do not consider these investments to be other-than-temporarily impaired at December 31, 2008.

Equity Securities

Our equity portfolio consists of common stock, REITs, preferred stocks, exchange traded funds and a high-yield municipal bond fund. The majority of our net unrealized losses are contained within the three exchange traded funds in the portfolio. We began diversifying our equity portfolio towards the end of 2007 with exchange traded funds. The exchange traded funds track various indices and have returns for 2008 consistent with the equity benchmark indices they follow. Given the short amount of time we owned these securities, the ETFs' position relative to the benchmarks they track, and forecasted recovery periods, we do not consider the exchange traded funds to be other-than-temporarily impaired at December 31, 2008.

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

(in thousands)	Amortized Cost	Fair Value
AVAILABLE-FOR-SALE		
Due in one year or less	\$ 16,317	\$ 16,465
Due after one year through five years	253,210	256,334
Due after five years through 10 years	442,644	433,793
Due after 10 years	524,505	517,623
	\$1,236,676	\$1,224,215
HELD-TO-MATURITY		
Due in one year or less	\$ 12,113	\$ 12,260
Due after one year through five years	25,320	26,627
Due after five years through 10 years	2,388	2,534
Due after 10 years	—	—
	\$ 39,821	\$ 41,421
TRADING		
Due in one year or less	\$ —	\$ —
Due after one year through five years	2,100	2,033
Due after five years through 10 years	2,888	2,774
Due after 10 years	5,294	5,213
	\$ 10,282	\$ 10,020
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
	\$1,286,779	\$1,275,656

Expected maturities may differ from contractual maturities due to call provisions on some existing securities and prepayment features on mortgage-backed, asset-backed, and collateralized mortgage obligations. At December 31, 2008, the net unrealized appreciation of available-for-sale fixed maturities and equity securities totaled \$23.0 million. At December 31, 2007, the net unrealized appreciation of available-for-sale fixed maturities and equity securities totaled \$146.7 million.

The following tables are also used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of December 31, 2008, and December 31, 2007, respectively. These tables segregate the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position.

DECEMBER 31, 2008 (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

DECEMBER 31, 2007			
(in thousands)	0-12 Mos.	>12 Mos.	Total
U.S. Government			
Fair value	\$ —	\$ —	\$ —
Cost or amortized cost	—	—	—
Unrealized loss	—	—	—
U.S. Agency			
Fair value	\$ —	\$ 70	\$ 70
Cost or amortized cost	—	70	70
Unrealized loss	—	—	—
Mtge/ABS/CMO*			
Fair value	\$ 7,892	\$ 87,746	\$ 95,638
Cost or amortized cost	8,000	89,230	97,230
Unrealized loss	(108)	(1,484)	(1,592)
Corporate			
Fair value	\$ 53,846	\$ 65,185	\$ 119,031
Cost or amortized cost	55,229	67,505	122,734
Unrealized loss	(1,383)	(2,320)	(3,703)
States, political subdivisions and revenues			
Fair value	\$ 42,218	\$ 46,604	\$ 88,822
Cost or amortized cost	42,472	46,738	89,210
Unrealized loss	(254)	(134)	(388)
Subtotal, debt securities			
Fair value	\$ 103,956	\$ 199,605	\$ 303,561
Cost or amortized cost	105,701	203,543	309,244
Unrealized loss	(1,745)	(3,938)	(5,683)
Common stock			
Fair value	\$ 56,808	\$ —	\$ 56,808
Cost or amortized cost	64,604	—	64,604
Unrealized loss	(7,796)	—	(7,796)
Preferred stock			
Fair value	\$ 29,436	\$ —	\$ 29,436
Cost or amortized cost	34,495	—	34,495
Unrealized loss	(5,059)	—	(5,059)
Total			
Fair value	\$ 190,200	\$ 199,605	\$ 389,805
Cost or amortized cost	204,800	203,543	408,343
Unrealized loss	(14,600)	(3,938)	(18,538)

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

As of December 31, 2008, we held 37 common and preferred stocks 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 position of greater than 20 percent for more than six months. The fixed income portfolio contained 229 securities at a 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 access 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 securities in an unrealized loss position are not other-than-temporarily impaired.

During 2008, we recognized impairment losses of \$76.2 million. This total includes \$64.2 million in equity and \$12.0 million in fixed income declines. Of the total charge, \$39.7 million came during the fourth quarter as the overall market continued its downward trend. The majority of our other-than-temporary impairment is 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.

At December 31, 2008, we were party to a securities lending program whereby fixed income securities are loaned to third parties, primarily major brokerage firms. At December 31, 2008, fixed maturities with a fair value of \$15.4 million were loaned. Agreements with custodian banks facilitating such lending generally require 102 percent of the value of the loaned securities to be separately maintained as collateral for each loan. Pursuant to SFAS 140, an invested asset and a corresponding liability have been recognized for the cash collateral amount. To further minimize the credit risks related to this lending program, we monitor the financial condition of other parties to these agreements.

As required by law, certain fixed maturities and short-term investments amounting to \$18.3 million at December 31, 2008, were on deposit with either regulatory authorities or banks. Additionally, we have certain fixed maturities held in trust amounting to \$10.0 million at December 31, 2008. These funds cover net premiums, losses, and expenses related to a property and casualty insurance program.

3. POLICY ACQUISITION COSTS

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

(in thousands)	2008	2007	2006
Deferred policy acquisition costs, beginning of year	\$ 78,882	\$ 73,817	\$ 69,477
Deferred:			
Direct commissions	110,985	119,344	126,270
Premium taxes	7,663	6,902	6,483
Other direct underwriting expenses	65,270	60,695	54,946
Ceding commissions	(27,438)	(31,454)	(41,520)
Net deferred	156,480	155,487	146,179
Amortized	156,842	150,422	141,839
Deferred policy acquisition costs, end of year	\$ 78,520	\$ 78,882	\$ 73,817
Policy acquisition costs:			
Amortized to expense	156,842	150,422	141,839
Period costs:			
Ceding commission – contingent	(2,683)	(3,334)	(3,049)
Other	9,161	8,522	6,986
Total policy acquisition costs	\$163,320	\$155,610	\$145,776

4. DEBT

As of December 31, 2008, outstanding debt balances totaled \$100.0 million, all of which was our long-term senior notes. The senior notes are rated Baa2 by Moody's and BBB+ by S&P.

On December 12, 2003, we completed a public debt offering, issuing \$100.0 million in senior notes maturing January 15, 2014, and paying interest semi-annually at the rate of 5.95 percent. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. The amount of the discount is being charged to income over the life of the debt on an effective-yield basis. Of the proceeds, capital contributions totaling \$65.0 million were made to our insurance subsidiaries to increase their statutory surplus. The balance of the proceeds was used by the holding company to fund investment and operating activities. The estimated fair value for the senior note is \$88.5 million. The fair value of our long-term debt

is estimated based on the limited observable prices that reflect thinly traded securities.

As of December 31, 2008, we had no short-term debt outstanding as compared to \$28.0 million outstanding under reverse repurchase agreements at December 31, 2007. 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 that would be paid in interest expense.

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. This facility has a three-year term that expires on May 31, 2011. As of December 31, 2008, no amounts were outstanding on this facility.

We incurred interest expense on debt at the following average interest rates for 2008, 2007, and 2006:

	2008	2007	2006
Line of credit	—	—	—
Reverse repurchase agreements	3.42%	5.15%	4.97%
Total short-term debt	3.42%	5.15%	4.97%
Senior notes	6.02%	6.02%	6.02%
Total debt	5.60%	5.88%	5.95%

Interest paid on outstanding debt for 2008, 2007, and 2006 amounted to \$6.7 million, \$7.0 million, and \$6.6 million, respectively.

5. REINSURANCE

In the ordinary course of business, the insurance subsidiaries assume and cede premiums with other insurance companies. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk (known as facultative reinsurance). In addition, there are several types of treaties including: quota share, excess of loss and catastrophe reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. The arrangements allow us to pursue greater diversification of business and serve to limit the maximum net loss on catastrophes and large risks. Through the quantification of exposed policy limits in each region and the extensive use of computer-assisted modeling techniques, we monitor the concentration of risks exposed to catastrophic events.

Through the purchase of reinsurance, we generally limit our net loss on any individual risk to a maximum of \$2.0 million, although retentions can range from \$0.5 million to \$7.5 million.

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

(in thousands)	2008	2007	2006
WRITTEN			
Direct	\$673,226	\$734,287	\$ 794,093
Reinsurance assumed	7,943	5,047	4,920
Reinsurance ceded	(167,713)	(200,571)	(247,477)
Net	\$513,456	\$538,763	\$ 551,536
EARNED			
Direct	\$695,824	\$765,894	\$ 788,904
Reinsurance assumed	5,218	5,729	5,982
Reinsurance ceded	(172,278)	(227,145)	(264,548)
Net	\$528,764	\$544,478	\$530,338
LOSSES AND SETTLEMENT EXPENSES INCURRED			
Direct	\$234,121	\$180,140	\$ 381,661
Reinsurance assumed	7,399	7,746	8,956
Reinsurance ceded	5,654	2,982	(133,728)
Net	\$247,174	\$190,868	\$ 256,889

Direct, ceded, and net losses and settlement expenses incurred, as displayed in the table above, were lower in 2007 and 2008 relative to 2006 due to favorable development on prior accident years' reserves. While we have experienced favorable development in all three years, there was a significant impact to direct, ceded, and net reserves during 2007. This was the direct result of several refinements in our loss reserve methodologies that culminated in significant favorable development on prior years' reserves. This is further outlined in note 6. Many of our longer-tailed products make extensive use of reinsurance. As a result, the favorable emergence we have seen on an overall basis has had an even more significant impact on our estimates of ceded reserves. This factor influenced the calendar year ceded incurred losses shown in the table for both 2007 and 2008.

At December 31, 2008, we had prepaid reinsurance premiums on paid and unpaid losses and settlement expenses totaling \$376.4 million. More than 91 percent of our reinsurance recoverables are due from companies rated "A" or better by A.M. Best and S&P rating services.

The following table displays net reinsurance balances recoverable, including collateral, from our top 10 reinsurers, as of December 31, 2008. All other reinsurance balances recoverable, when considered by individual reinsurer, are less than 2 percent of shareholders' equity.

REINSURER (in thousands)	Amounts Recoverable	A.M Best Rating	S&P Rating
Munich Re America	\$59,716	A+, Superior	AA-, Very Strong
Swiss Re/Westport Ins. Corp.	41,660	A+, Superior	A+, Strong
Endurance Re	40,632	A, Excellent	A, Strong
Axis Re	32,743	A, Excellent	A, Strong
General Cologne Re	31,839	A++, Superior	AAA, Extremely Strong
Berkley Insurance Co.	28,202	A+, Superior	A+, Strong
Toa-Re	17,916	A, Excellent	A+, Strong
Lloyds of London	15,184	A, Excellent	A+, Strong
Ace Property & Casualty	15,078	A+, Superior	A+, Strong
Transatlantic Re	14,892	A, Excellent	AA-, Very Strong

6. HISTORICAL LOSS AND LAE DEVELOPMENT

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

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

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

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

(FAVORABLE)/UNFAVORABLE RESERVE DEVELOPMENT BY SEGMENT

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

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

2008. During 2008, we experienced favorable loss emergence from prior years' reserve estimates across all of our segments. For our casualty segment, we experienced \$50.6 million of favorable development, predominantly from the accident years of 2002-2006. In retrospect, the expected loss ratios initially used to set booked reserves for these accident years have proven to be conservative, which has resulted in loss emergence significantly lower than expected. This is particularly true for our general liability, personal umbrella, and commercial umbrella products, which experienced favorable loss development of \$33.1 million, \$12.7 million, and \$11.8 million, respectively. The construction class was the largest contributor to the favorable emergence in the general liability product. In addition, our program business experienced \$9.3 million of unfavorable prior years' loss development during the year, mostly isolated in accident years 2004-2007. Our experience in the liquor liability class has been particularly adverse. In the past, we relied on external loss development

patterns that have not proven predictive of actual emergence. As a result, this class is being re-underwritten and we implemented a more stringent reserving approach in 2008.

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

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

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

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

Based on this review, we made certain refinements to our reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves through increased internal dialogue among the claim, underwriting, risk management and actuarial departments, greater transparency of the actuarial process and results, and improved reserving diagnostics. Overall, these enhancements and improved information provide better and faster feedback to management regarding loss development resulting in greater overall confidence in the actuarial estimates. This and the increased stability in our business in the last few years diminished the needed level

of carried reserves above the actuarial point estimate. We believe that these reserve methodology enhancements improved the overall accuracy of our best estimate of loss and LAE reserves. Over half of the favorable prior years' loss development was the result of this detailed assessment and resulting changes in our booked reserves.

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

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

The surety segment realized \$11.1 million of favorable prior years' development. Almost all of the development was the result of the risk reassessment and reflection of significantly lower reserve risk after achieving settlement with the larger banks involved in the CMC litigation (see note 10 for more details).

2006. During 2006, we continued to experience favorable loss development and a reduction in prior years' loss reserve estimates. Pricing increased substantially and policy terms and conditions became more favorable for most of our products during the 2001-2004 policy years. Many of the improvements in market conditions were difficult to quantify at the time of the original estimate. Our significant growth in premium and exposures made precise quantification of these changes even more challenging. In 2006, losses continued to emerge on the prior accident years much more favorably than we expected when making our original estimates. We experienced favorable development of \$43.4 million in aggregate on prior years' estimates.

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

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

ENVIRONMENTAL, ASBESTOS, AND MASS TORT EXPOSURES

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

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

(in thousands)	2008	2007	2006
LOSS AND LAE PAYMENTS			
Gross	\$70,210	\$56,060	\$ 53,323
Ceded	(39,143)	(30,607)	(29,853)
Net	\$31,067	\$25,453	\$ 23,470
UNPAID LOSSES AND LAE AT END OF YEAR			
Gross	\$65,583	\$67,891	\$ 48,541
Ceded	(20,407)	(29,198)	(25,720)
Net	\$45,176	\$38,693	\$ 22,821

Our environmental, asbestos, and mass tort exposure is limited, relative to other insurers, as a result of entering the affected liability lines after the insurance industry had already recognized environmental and asbestos exposure as a problem and adopted appropriate coverage exclusions.

During 2008, payment activity was more than we experienced in 2007, which was not surprising, given the increased amount of case reserve activity during 2007. However, we did not observe a corresponding decrease in case reserves, as gross case reserves decreased by only \$4.8 million while net case reserves increased by about \$0.5 million. Much of the reported adverse development can be tied to a small number of claims. Two related asbestos claims from our assumed reinsurance book accounted for \$2.7 million in gross emergence and \$2.1 million in net emergence with large payments being made. A mass tort claim from accident year 2005 against an insured hotel involving carbon monoxide discharge accounted for another \$1.6 million direct and \$1.0 million net. In light of these developments and a few additional reported claims, we decided to strengthen our IBNR position.

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

our excess policy had been exhausted. In addition to these case reserve increases, we made a minor adjustment in our emergence pattern assumptions that resulted in an increase in our total reserve position relative to industry benchmarks.

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

7. INCOME TAXES

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

(in thousands)	2008	2007
Deferred tax assets:		
Tax discounting of claim reserves	\$32,728	\$ 35,800
Unearned premium offset	18,843	19,915
Net unrealized depreciation of securities	4,912	—
Other	6,999	10,203
Deferred tax assets before allowance	63,482	65,918
Less valuation allowance	—	—
Total deferred tax assets	\$63,482	\$ 65,918
Deferred tax liabilities:		
Net unrealized appreciation of securities	\$ —	\$ 51,757
Deferred policy acquisition costs	27,482	27,609
Book/tax depreciation	1,823	1,635
Undistributed earnings of unconsolidated investee	9,773	9,700
Other	263	259
Total deferred tax liabilities	39,341	90,960
Net deferred tax asset (liability)	\$24,141	\$(25,042)

Income tax expense attributable to income from operations for the years ended December 31, 2008, 2007, and 2006, differed from the amounts computed by applying the U.S. federal tax rate of 35 percent to pretax income from continuing operations as demonstrated in the following table:

(in thousands)	2008	2007	2006
Provision for income taxes at the statutory federal tax rates	\$37,309	\$89,067	\$65,413
Increase (reduction) in taxes resulting from:			
Dividends received deduction	(1,830)	(1,815)	(1,858)
ESOP dividends paid deduction	(508)	(471)	(469)
Tax-exempt interest income	(6,418)	(6,276)	(5,885)
Non-recurring tax benefit	—	(2,356)	(3,171)
Other items, net	(631)	460	(1,776)
Total	\$27,922	\$78,609	\$52,254

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 net realized losses, which were taxed at 35.0 percent. In addition, changes in items that are non-taxable, such as tax-exempt interest income, impact the effective tax rate. 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 (IRS) concluded an examination of our tax years 2000 through 2004. As a result of this exam, we recorded a \$3.2 million tax benefit, resulting from a change in tax estimate related to the sale of assets.

Our net earnings include equity in earnings of unconsolidated investees. These investees do not have a policy or pattern of paying dividends. As a result, we record a deferred tax liability on these earnings at the corporate capital gains rate of 35 percent. In the third quarter of 2008, we received a \$4.0 million dividend from Maui Jim. As required by SFAS 109, "Accounting for Income Taxes," we recognized a \$1.1 million tax benefit in 2008 from applying the lower tax rate applicable to affiliated dividends as compared to the corporate capital gains rate on which the deferred tax liabilities were based. This benefit is included in the other items, net caption in the previous table. In the first quarter of 2007, we received a cash dividend of \$5.9 million and recognized a \$1.7 million tax benefit in 2006 from applying the lower tax rate. A dividend was also paid

in 2006 by Maui Jim in the amount of \$16.5 million and a \$4.6 million tax benefit was recorded in 2005 from applying the lower tax rates. Although a dividend has been received for three straight years, we do not anticipate the payment of dividends to continue and expect to recover our investment through means other than receipt of dividends. On December 28, 2006, we sold our equity investment in TBW. This resulted in a realized capital gain of \$16.2 million with a corresponding current tax expense of \$5.7 million and the current recognition of tax expense of \$5.5 million from the previously deferred tax expense on undistributed earnings of this unconsolidated investee.

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

Net federal and state income taxes paid in 2008, 2007, and 2006 amounted to \$31.6 million, \$87.8 million, and \$53.1 million, respectively.

8. EMPLOYEE BENEFITS

PENSION PLAN

During 2003 through 2006, our board and management took a series of steps to freeze and terminate our defined benefit pension plan. The plan termination was finalized in 2006. All plan distributions were made in late 2006.

In 2006, we paid \$14.4 million in benefits and had no remaining benefit obligation at December 31, 2006. We incurred \$2.6 million in pension expense in 2006. No expenses were incurred in 2007 or 2008.

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

EMPLOYEE STOCK OWNERSHIP, 401(K) AND BONUS AND INCENTIVE PLANS

We maintain an Employee Stock Ownership Plan (ESOP), 401(k), and bonus and incentive plans covering executives, managers, and associates. At the board's discretion, funding of these plans is primarily dependent upon reaching predetermined levels of operating return on equity and Market Value Potential (MVP). MVP is a compensation model that measures comprehensive earnings against a minimum required return on our capital. Bonuses are earned as we generate earnings in excess of this required return. While some management incentive plans may be affected somewhat by other performance factors, the larger influence of corporate performance ensures that the interests of our executives, managers, and associates correspond with those of our shareholders.

Our 401(k) plan allows voluntary contributions by employees and permits ESOP diversification transfers for employees meeting certain age or service requirements. We provide a basic 401(k) contribution of 3 percent of eligible compensation. Participants are 100 percent vested in both voluntary and basic contributions. Additionally, an annual discretionary profit-sharing contribution may be made to the ESOP and 401(k), subject to the achievement of certain overall financial goals. For plan years prior to 2007, profit-sharing contributions were subject to a five-year cliff vest. For plan year 2007 and later, contributions vest after three years of service.

Our ESOP and 401(k) cover all employees meeting eligibility requirements. ESOP and 401(k) profit-sharing contributions are determined annually by our board of directors and are expensed in the year earned. ESOP and 401(k)-related expenses (basic and profit-sharing) were \$8.8 million, \$9.8 million and \$7.9 million, respectively, for 2008, 2007, and 2006.

During 2008, the ESOP purchased 118,902 shares of RLI stock on the open market at an average price of \$53.85 (\$6.4 million) relating to the contribution for plan year 2007. Shares held by the ESOP as of December 31, 2008, totaled 1,476,635 and are treated as outstanding in computing our earnings per share. During 2007, the ESOP purchased 90,561 shares of RLI stock on the open market at an average price of \$57.92 (\$5.2 million) relating to the contribution for plan year 2006. During 2006, the ESOP purchased 94,430 shares of RLI stock on the open market at an average price of \$54.19 (\$5.1 million) relating to the contribution for plan year 2005.

Annual bonuses are awarded to executives, managers, and associates through our incentive plans, provided certain financial and operational goals are met. Annual expenses for these incentive plans totaled \$4.6 million, \$15.8 million and \$15.1 million for 2008, 2007, and 2006, respectively.

DEFERRED COMPENSATION

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

The expense associated with funding these plans is recognized through salary and bonus expenses for key employees and executive officers. The expense recognized from the directors' deferred plan was \$0.5 million, \$0.5 million and \$0.4 million in 2008, 2007, and 2006, respectively.

In 2008, the trusts purchased 18,496 shares of common stock on the open market at an average price of \$51.62 (\$1.0 million). In 2007, the trusts purchased 13,013 shares of our common stock on the open market at an average price of \$56.76 (\$0.7 million). In 2006, the trusts purchased 13,913 shares of our common stock on the open market at an average price of \$51.61 (\$0.7 million). At December 31, 2008, the trusts' assets were valued at \$22.9 million.

STOCK OPTION AND STOCK PLANS

During 1995, we adopted and the shareholders approved a tax-favored incentive stock option plan (the incentive plan). During 1997, the shareholders approved the Outside Directors' Stock Option Plan (the directors' plan). Normal vesting for options granted was pro rata over five years under the incentive plan and pro rata over three years under the directors' plan with a 10-year life for both plans. The plans provided for grants of up to 3,125,000 shares under the incentive plan and 500,000 shares under the directors' plan. Through May 5, 2005, we had granted 2,640,188 options under these plans.

During 2005, our shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). In conjunction with the adoption of this plan, effective May 5, 2005, options will no longer be granted under the two other option plans previously in existence. The purpose of the omnibus plan is to promote our interests and those of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a high level of corporate performance and to encourage our continued success and growth. Awards under the omnibus plan may be in the form of restricted stock, stock options (both incentive and nonqualified), stock appreciation rights, performance units, as well as other

stock based awards. Eligibility under the omnibus plan is limited to our employees or employees of any affiliate and to individuals or entities who are not employees but who provide services to us or an affiliate, including services provided in the capacity of consultant, advisor or director. The granting of awards is solely at the discretion of the executive resources committee and the board of directors. The total number of shares of common stock available for distribution under the omnibus plan may not exceed 1,500,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we have granted 948,100 stock options under this plan, including 267,000 in 2008.

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

Shares issued may be less than the number of shares actually exercised, as our plan allows participants to swap shares to cover the option exercise price and taxes due upon option exercise. Shares swapped are valued at the closing stock price on the date of option exercise. In these instances, the actual number of shares issued will be less than the options exercised and can result in a decrease to shareholders' equity. Specifically, when options are exercised with significant intrinsic value (i.e. market value in excess of exercise price) and the exercise is facilitated via a stock swap, amounts withheld for taxes result in a decrease in shareholders' equity. During 2008, the aggregate intrinsic value of options exercised was \$16.6 million. A majority of these options were exercised via stock swaps with taxes withheld at the statutory minimum rate. As shown in the Consolidated Statements of Shareholders' Equity, the exercise of options in 2008 resulted in a decrease to paid-in-capital, as the taxes withheld pursuant to swaps exceeded amounts paid in for options that were exercised using cash.

The following tables summarize option activity in 2008, 2007, and 2006:

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2008	1,605,252	\$36.34		
Options granted	267,000	\$51.03		
Options exercised	(439,404)	\$22.37		\$16,616
Options cancelled/forfeited	(3,720)	\$50.04		
Outstanding options at December 31, 2008	1,429,128	\$43.35	6.46	\$23,999
Exercisable options at December 31, 2008	853,367	\$37.12	5.07	\$19,645

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2007	1,632,019	\$31.30		
Options granted	241,300	\$56.15		
Options exercised	(261,527)	\$22.76		\$9,255
Options cancelled/forfeited	(6,540)	\$49.83		
Outstanding options at December 31, 2007	1,605,252	\$36.34	5.84	\$32,822
Exercisable options at December 31, 2007	1,206,951	\$30.57	4.81	\$31,642

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

The majority of our options are granted annually at the board meeting in May. In 2008, 267,000 options were granted with an average exercise price of \$51.03 and an average fair value of \$13.01. Of these grants, 218,000 were granted at the board meeting in May with a calculated fair value of \$12.38. We recognized \$2.6 million of expense during 2008 related to options vesting. Since options

granted under our plan are non-qualified, we recorded a tax benefit of \$0.9 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.3 million, which will be recognized over the remainder of the vesting period.

In 2007, 241,300 options were granted with an average exercise price of \$56.15 and an average fair value of \$15.15. Of these grants, 202,600 were granted at the board meeting in May with a calculated fair value of \$15.11. We recognized \$1.8 million of expense during 2007 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.6 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$3.5 million, which will be recognized over the remainder of the vesting period.

In 2006, 206,300 options were granted with an average exercise price of \$50.31 and an average fair value of \$13.95. Of these grants, 171,900 were granted at the board meeting in May 2006 with a calculated fair value of \$13.97. We recognized \$0.8 million of expense during 2006 related to 2006 grants. Since options granted in 2006 were non-qualified, we recorded a tax benefit of \$0.3 million in 2006 related to this compensation expense. Total unrecognized compensation expense in 2006 relating to these grants was \$1.9 million, which will be recognized over the remainder of the five-year vesting period.

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

	2008	2007	2006
Weighted-average fair value of grants	\$13.01	\$15.15	\$13.95
Risk-free interest rates	3.29%	4.56%	4.99%
Dividend yield	1.53%	1.47%	1.51%
Expected volatility	24.01%	21.78%	22.35%
Expected option life	6.40 years	6.95 years	6.31 years

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

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

Total shares granted to outside directors under the omnibus plan were 4,700 in 2008, 2,949 in 2007 and 7,267 in 2006. Shares were granted at an average share price of \$53.83 in 2008, \$57.51 in 2007 and \$51.72 in 2006. In 2006, 3,452 of the shares granted were issued under the directors' deferred plan. We recognized \$0.3 million of expense relating to grants in 2008, compared to \$0.2 million in 2007 and \$0.4 million in 2006.

POST-RETIREMENT BENEFITS OTHER THAN PENSION

In 2002, we began offering certain eligible employees post-employment medical coverage. Under our plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under our health plan. Former employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. We expect a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees has historically covered the cost of providing this coverage.

9. STATUTORY INFORMATION AND DIVIDEND RESTRICTIONS

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

Year-end statutory surplus presented in the table below includes \$31.3 million of RLI stock (cost basis of \$64.6 million) held by Mt. Hawley Insurance Company. The Securities Valuation Office provides specific guidance for valuing this investment, which is eliminated in our consolidated financial statements.

The following table includes selected information for our insurance subsidiaries for the year ending and as of December 31:

(in thousands)	2008	2007	2006
Consolidated net income, statutory basis	\$ 74,478	\$177,307	\$136,135
Consolidated surplus, statutory basis	\$678,041	\$752,004	\$746,905

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 Ins. policyholder surplus as of December 31 of the preceding year or the net income of the Company for the 12-month period ending December 31 of the preceding year. Stand-alone net income for RLI Ins. was \$26.7 million for 2008. 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 RLI Ins.'s policyholder surplus at December 31, 2008. The 12-month rolling limitation for 2008, based on the above criteria, was \$126.2 million. In 2008, a total cash dividend of \$70.0 million was 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. In 2007, a total cash dividend of \$149.7 million was paid by RLI Ins. after obtaining permission for special dividends from the Illinois Department of Insurance.

10. COMMITMENTS AND CONTINGENT LIABILITIES

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

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

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

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

claims total approximately \$9.3 million). The settlements with Sky Bank and Ameriana Bank related to surety bonds representing approximately 66 percent of the amount to which the five investor banks had claimed entitlement. In the first quarter of 2008, we reached a confidential settlement agreement with the Bank of Waukegan. In the fourth quarter of 2008, we reached a confidential settlement agreement with Atlantic Coast Federal Bank. The settlements with Bank of Waukegan and Atlantic Coast Federal related to surety bonds representing approximately 17 percent of the amount to which the five investor banks had claimed entitlement. With these latter two settlements, we have now reached settlements with each of the five investor banks that had claimed entitlement under the surety bonds issued by RLI.

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

We have capital lease obligations for leased computers and operating lease obligations for regional office facilities. These leases expire in various years through 2014. Expense associated with these leases totaled \$3.9 million in 2008, \$3.7 million in 2007 and \$3.4 million in 2006. Minimum future rental payments under noncancellable leases are as follows:

(in thousands)

2009	\$ 3,676
2010	3,257
2011	2,644
2012	2,336
2013	939
2014	96
Total minimum future rental payments	\$12,948

11. OPERATING SEGMENT INFORMATION

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

The segments of our insurance operations include casualty, property, and surety. The casualty segment includes

liability coverages where loss and related settlement expenses are subject to greater estimation, as the ultimate disposition of claims may take several years to fully develop. Policy coverage is more significantly impacted by evolving legislation and court decisions.

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

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

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

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

REVENUES

(in thousands)	2008	2007	2006
Casualty	\$313,481	\$343,402	\$348,217
Property	146,863	138,367	122,581
Surety	68,420	62,709	59,540
Segment totals before income taxes	\$528,764	\$544,478	\$530,338
Net investment income	78,986	78,901	71,325
Net realized gains (losses)	(46,738)	28,966	31,045
Total	\$561,012	\$652,345	\$632,708

DEPRECIATION AND AMORTIZATION

(in thousands)	2008	2007	2006
Casualty	\$1,648	\$1,825	\$2,086
Property	872	891	963
Surety	604	588	501
Segment totals before income taxes	\$3,124	\$3,304	\$3,550

NET EARNINGS (LOSSES)

(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
Net Underwriting Income	\$ 83,063	\$155,765	\$ 84,056
Net investment income	78,986	78,901	71,325
Realized gains (losses)	(46,738)	28,966	31,045
General corporate expense and interest on debt	(13,557)	(16,471)	(14,650)
Equity in earnings of unconsolidated investees	4,844	7,315	15,117
Total earnings before income taxes	\$106,598	\$254,476	\$186,893
Income taxes	27,922	78,609	52,254
Total	\$ 78,676	\$175,867	\$134,639

The following table further summarizes revenues by major product 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			
	\$ 68,420	\$ 62,709	\$ 59,540
Grand total	\$528,764	\$544,478	\$530,338

12. UNAUDITED INTERIM FINANCIAL INFORMATION

Selected quarterly information is as follows:

(in thousands, except per share data)	First	Second	Third	Fourth	Year
2008					
Net premiums earned	\$135,965	\$132,295	\$130,850	\$129,654	\$528,764
Net investment income	19,258	19,605	19,844	20,279	78,986
Net realized investment gains (losses)	3,741	8,075	(24,212)	(34,342)	(46,738)
Earnings before income taxes	35,961	57,121	7,696	5,820	106,598
Net earnings	25,459	38,650	8,586	5,981	78,676
Basic earnings per share ⁽¹⁾	\$1.16	\$1.80	\$0.40	\$0.28	\$3.65
Diluted earnings per share ⁽¹⁾	\$1.14	\$1.77	\$0.40	\$0.28	\$3.60
2007					
Net premiums earned	\$137,977	\$137,488	\$134,111	\$134,902	\$544,478
Net investment income	18,990	19,077	20,433	20,401	78,901
Net realized investment gains	4,625	14,967	3,822	5,552	28,966
Earnings before income taxes	47,138	73,847	87,355	46,136	254,476
Net earnings	32,517	49,853	61,539	31,958	175,867
Basic earnings per share ⁽¹⁾	\$1.35	\$2.09	\$2.61	\$1.41	\$7.46
Diluted earnings per share ⁽¹⁾	\$1.32	\$2.04	\$2.56	\$1.38	\$7.30

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