

MANAGEMENT'S DISCUSSION AND ANALYSIS

OVERVIEW

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

The foundation of our overall business strategy is to underwrite for profit in all marketplaces, and we have achieved this for 14 consecutive years, averaging an 88.1 combined ratio over that period of time. This foundation drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly rated, diversified, liquid investment-grade securities. Regular underwriting income allows a portion of our shareholders' equity to be invested in equity securities. Our equity portfolio consists of a core stock portfolio weighted toward dividend-paying stocks, as well as exchange traded funds (ETFs). Private equity investments, primarily our minority ownership in Maui Jim, Inc. (Maui Jim), have also enhanced overall returns. We have a diversified investment portfolio and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite fluctuations of realized and unrealized gains and losses in the equity portfolio, our investment in equity securities as part of a long-term asset allocation strategy has contributed significantly to our historic growth in book value.

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

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

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

The surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical and refining industries. We offer miscellaneous bonds, including license and permit, notary and court bonds. We also offer fidelity and crime coverage for commercial insureds and select financial institutions. Often, our surety coverages involve a statutory requirement for bonds. While these bonds have maintained a relatively low loss ratio, losses may fluctuate due to adverse economic conditions that may affect the financial viability of an insured. The contract surety marketplace guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic

conditions or the deterioration of a contractor's financial condition. As such, this line has historically produced marginally higher loss ratios than other surety lines.

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

GAAP AND NON-GAAP FINANCIAL PERFORMANCE METRICS

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

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

Underwriting Income

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

Gross Premiums Written

While net premiums earned is the related GAAP measure used in the statements of earnings, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this

measure as an overall gauge of gross business volume in our insurance underwriting operations with some indication of profit potential subject to the levels of our retentions, expenses and loss costs.

Net Premiums Written

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

Combined Ratio

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

Net Unpaid Loss and Settlement Expenses

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

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

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation and other-than-temporary impairment (OTTI), recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes.

CRITICAL ACCOUNTING POLICIES

LOSSES AND SETTLEMENT EXPENSES

Overview

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

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

Due to inherent uncertainty underlying loss reserve estimates, including, but not limited to, the future settlement

environment, final resolution of the estimated liability may be different from that anticipated at the reporting date. Therefore, actual paid losses in the future may yield a materially different amount than currently reserved — favorable or unfavorable.

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

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

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

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

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

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

All decisions regarding our best estimate of ultimate loss and LAE reserves are made by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at December 31, 2009, make a reasonable provision to meet our future obligations.

Initial IBNR Generation Process

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

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

We do not reserve for natural or man-made catastrophes until an event has occurred. Shortly after such occurrence, we review insured locations exposed to the event, model

loss estimates based on our own exposures, industry loss estimates of the event, and we also consider our knowledge of frequency and severity from early claim reports to determine an appropriate reserve for the catastrophe. These reserves are reviewed frequently based on actual losses reported and appropriate changes to our estimates are made to reflect the new information.

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

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

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

Loss and LAE Reserve Estimation Process

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

The process of estimating ultimate payment for claims and claims expenses begins with the collection and analysis of current and historical claim data. Data on individual reported claims including paid amounts and individual claim adjuster estimates are grouped by common characteristics. There is judgment involved in this grouping. Considerations when grouping data include the volume of the data available,

the credibility of the data available, the homogeneity of the risks in each cohort and both settlement and payment pattern consistency. We use this data to determine historical claim reporting and payment patterns which are used in the analysis of ultimate claim liabilities. For portions of the business without sufficiently large numbers of policies or that have not accumulated sufficient historical statistics, our own data is supplemented with external or industry average data as available and when appropriate. For our new products, as well as for executive products and marine business, we utilize external data extensively.

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

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

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

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

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

- Loss payment patterns,
- Loss reporting patterns,
- Frequency and severity trends,
- Underlying policy terms and conditions,
- Business or exposure mix,
- Operational or internal process changes affecting timing of recording transactions,
- Regulatory and legal environment, and/or
- Economic environment.

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

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

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

Determination of Our Best Estimate

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

As a predominantly excess and surplus lines and specialty insurer servicing niche markets, we believe there are several reasons to carry — on an overall basis — reserves above the

actuarial point estimate. We believe we are subject to above-average variation in estimates and that this variation is not symmetrical around the actuarial point estimate.

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

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

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

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

Loss reserve estimates are subject to a high degree of variability due to the inherent uncertainty of ultimate settlement values. Periodic adjustments to these estimates will likely occur as the actual loss emergence reveals itself over time. We believe our loss reserving processes reflect industry best practices and our methodologies result in a reasonable provision for reserves as of December 31, 2009.

INVESTMENT VALUATION AND OTTI

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

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

We regularly evaluate our fixed income and equity securities using both quantitative and qualitative criteria to determine impairment losses for other-than-temporary declines in the fair value of the investments. The following are some of the key factors we consider 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, the issuer seeking protection from creditors under the bankruptcy laws, or the issuer 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,
- The probability that we will recover the entire amortized cost basis of our fixed income securities, or
- For our equity securities, our expectation of recovery to cost within a reasonable period of time.

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 fixed income securities to maturity or the equity

securities until forecasted recovery. In addition, we consider price declines of securities in our OTTI 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.

Key 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.

For mortgage-backed securities and asset-backed securities that have significant unrealized loss positions and major rating agency downgrades, credit impairment is assessed using a cash flow model that estimates likely payments using security-specific collateral and transaction structure. All our mortgage-backed and asset-backed securities remain AAA rated by the major rating agencies and the fair value is not significantly less than amortized cost. In addition, the current cash flow assumptions are the same assumptions used at purchase which reflects no credit issues at this time.

Under current accounting standards, an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered by circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security's amortized cost and its fair value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.

Part of our evaluation of whether particular securities are other-than-temporarily impaired involves assessing whether we have both the intent and ability to continue to hold equity securities in an unrealized loss position. For fixed income securities, we consider our intent to sell a security (which is determined on a security-by-security basis) and whether it is more-likely-than-not we will be required to sell the security before the recovery of our amortized cost basis. Significant

changes in these factors could result in a charge to net earnings for impairment losses. Impairment losses result in a reduction of the underlying investment's cost basis.

RECOVERABILITY OF REINSURANCE BALANCES

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

DEFERRED POLICY ACQUISITION COSTS

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

DEFERRED TAXES

We record net deferred tax assets to the extent temporary differences representing future deductible items exceed future taxable items. A significant amount of our

deferred tax assets relate to expected future tax deductions arising from claim reserves and future taxable income related to changes in our unearned premium.

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

We consider uncertainties in income taxes and recognize those in our financial statements as required. As it relates to uncertainties in income taxes, our unrecognized tax benefits, including interest and penalty accruals, are not considered material to the consolidated financial statements. Also, no tax uncertainties are expected to result in significant increases or decreases to unrecognized tax benefits within the next 12-month period. Penalties and interest related to income tax uncertainties, should they occur, would be included in tax expense.

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

RESULTS OF OPERATIONS

Consolidated revenue, as displayed in the table that follows, totaled \$546.6 million for 2009, compared to \$561.0 million in 2008 and \$652.3 million in 2007.

| CONSOLIDATED REVENUE (in thousands) | Year ended December 31, | | |
|--|-------------------------|-----------|-----------|
| | 2009 | 2008 | 2007 |
| Net premiums earned | \$491,961 | \$528,764 | \$544,478 |
| Net investment income | 67,346 | 78,986 | 78,901 |
| Net realized investment gains (losses) | (12,755) | (46,738) | 28,966 |
| Total consolidated revenue | \$546,552 | \$561,012 | \$652,345 |

Revenue was down in 2009 and 2008, as premiums earned from insurance operations declined and investment results were negatively impacted by a declining interest rate environment and turmoil in the financial markets. Net premiums earned declined 7 percent in 2009, following a 3 percent decline in 2008. Both periods were impacted by the results of our casualty segment, which was affected by the weak economy and continued rate softening. Declines in casualty premium served to more than offset increased premium writings of our property and surety segments and the subsequent earning of that premium as revenue. Investment income declined in 2009 as a result of lower reinvestment rates, dividend cuts and changes in asset allocation. In 2008, while interest rates were declining, investment income had remained flat due to shift in asset mix toward higher-yielding securities (preferred stock and high-yield municipal bond fund). During 2009, we recorded \$12.8 million in net realized investment losses. Turmoil in the equity and financial markets, which began in the last half of 2008, continued through the first part of 2009 and resulted in the recognition of additional investment losses, primarily from other-than-temporarily impaired securities. During 2008, we recorded \$46.7 million in net realized investment losses, primarily from other-than-temporarily impaired securities. Impairment charges were recorded on a high-yield municipal bond fund and securities in the financial sector, as the credit crisis and financial turmoil negatively impacted fixed income and equity values in the latter half of 2008. In 2007, realized gains, associated with the sale of certain equity securities deemed to have reached their full potential, contributed significantly to revenue.

| NET EARNINGS (in thousands) | Year ended December 31, | | |
|--|-------------------------|-----------|-----------|
| | 2009 | 2008 | 2007 |
| Underwriting income | \$ 86,785 | \$ 83,063 | \$155,765 |
| Net investment income | 67,346 | 78,986 | 78,901 |
| Net realized investment gains (losses) | (12,755) | (46,738) | 28,966 |
| Debt interest | (6,050) | (6,704) | (6,997) |
| Corporate expenses | (7,941) | (6,853) | (9,474) |
| Investee earnings | 5,052 | 4,844 | 7,315 |
| Pretax earnings | \$132,437 | \$106,598 | \$254,476 |
| Income tax | (38,592) | (27,922) | (78,609) |
| Net earnings | \$ 93,845 | \$ 78,676 | \$175,867 |

Net earnings increased in 2009, following a decline in 2008, which was severely impacted by net realized investment losses. Net earnings for 2007 represented an earnings record for the company. Results for 2009 and 2007 benefited from benign catastrophe seasons, while results for 2008 were impacted by \$24.0 million in hurricane losses. Underwriting income for all three periods benefited from favorable emergence on prior accident years' reserves.

Underwriting income was \$86.8 million in 2009, compared to \$83.1 million in 2008 and \$155.8 million in 2007. The result for each of these periods was the product of disciplined underwriting in the current accident year, coupled with favorable development on prior accident years' reserves. In a soft market, as we have seen in the past several years, disciplined underwriting can result in a reduction in premium revenue. This discipline, however, can differentiate us from the broader insurance market by ensuring more adequate pricing of both new and renewal business and can serve to slow the pace of deterioration in underwriting results. In 2009, we experienced \$66.6 million in favorable development on prior accident years' reserves, compared to favorable development of \$62.3 million in 2008 and \$105.2 million in 2007. Further discussion of reserve development can be found in note 6 to the financial statements.

Bonuses earned by executives, managers and associates are predominately influenced by corporate performance, including operating earnings and return on capital. Return on capital measures comprehensive earnings against a minimum required return on capital. Return on capital is the sole measure of executive bonus achievement and represents nearly one third of all manager and associate bonus targets. Bonus and profit sharing-related expenses attributable to operating earnings were increased in 2009, 2008 and 2007 due to the aforementioned favorable reserve developments. In addition, the level of comprehensive earnings (loss) achieved impacted bonus and profit sharing amounts earned. Comprehensive earnings were \$156.1 million in 2009, compared to a comprehensive loss of \$1.9 million in 2008 and comprehensive earnings of \$166.4 million in 2007. As a result of comprehensive earnings and the improved return on capital in 2009, bonus and profit sharing amounts increased \$11.7 million. In 2008, the comprehensive loss resulted in the elimination of bonus and profit-sharing amounts earned based on return on capital. Performance-related expenses impact policy acquisition, insurance operating and general corporate expenses line items in the financial statements. While performance-related expenses increased in 2009, expense control efforts began in 2008 and were continued in 2009. These efforts resulted in reductions to non-acquisition/non-production expenses, which served to reduce the amount of insurance operating and general corporate expenses recorded.

Over the past several years, we have invested in our capacity to produce premium. We have expanded our geographic footprint of existing products by adding underwriters and entering new markets, and we have hired

teams of underwriters to start new products. As a result, our policy acquisition costs, which include the expenses associated with this expansion, represent an increased percentage of net premiums earned in both 2009 and 2008. We believe this investment has positioned us well to capitalize on future market opportunities.

Equity in earnings of unconsolidated investee (Maui Jim) increased in 2009, after declining in 2008. Investee results for both periods were affected by the economic slowdown and ensuing effect on consumer discretionary spending. Results for 2008, however, were also impacted by foreign exchange losses.

RLI INSURANCE GROUP

In general, we have experienced continued softening in the marketplace over the last several years. As reflected in the following table, premium writings were down in 2009 and 2008. Increased competition and capacity in the marketplace have resulted in rate declines, particularly in our casualty segment. In addition to the general soft pricing environment, the weak economy has put additional pressure on exposure bases. Insurance premiums in our markets are heavily dependent on our customer revenues, values transported, miles traveled and number of new projects initiated. While declines in these factors reduce insured exposure, they have a corresponding decrease to premiums written. Overall, casualty writings declined 17 percent in 2009, following a decline of 13 percent in 2008. On the property side, premium increased 3 percent in 2009, after declining in 2008. The result for 2009 was driven by increased premium in facultative reinsurance, a new coverage launched in 2007. Our surety segment posted increased premium in 2009 and 2008. We hired a team of fidelity underwriters in late 2008 and have added underwriters and expanded geographically in miscellaneous and contract surety.

Our underwriting income and combined ratios are displayed in the tables below. Solid underwriting results for the casualty and surety segments were magnified by favorable development on prior accident years' loss reserves in each of the last three years. The property segment was impacted by hurricane losses in 2008, while 2009 and 2007 benefited from light hurricane seasons. Property results for 2009, however, were negatively impacted by unfavorable loss experience on current and prior accident years for marine

coverages. The following table and narrative provide a more detailed look at individual segment performance over the last three years.

| GROSS PREMIUMS WRITTEN (in thousands) | Year ended December 31, | | |
|--|-------------------------|------------------|------------------|
| | 2009 | 2008 | 2007 |
| Casualty | \$333,059 | \$403,337 | \$462,591 |
| Property | 207,444 | 200,794 | 206,041 |
| Surety | 90,697 | 77,038 | 70,702 |
| Total | \$631,200 | \$681,169 | \$739,334 |
| UNDERWRITING INCOME | | | |
| (in thousands) | 2009 | 2008 | 2007 |
| Casualty | \$51,488 | \$46,507 | \$101,863 |
| Property | 23,261 | 15,813 | 30,569 |
| Surety | 12,036 | 20,743 | 23,333 |
| Total | \$86,785 | \$83,063 | \$155,765 |
| COMBINED RATIO | | | |
| (in thousands) | 2009 | 2008 | 2007 |
| Casualty | 80.6 | 85.2 | 70.3 |
| Property | 85.0 | 89.3 | 77.9 |
| Surety | 83.2 | 69.7 | 62.8 |
| Total | 82.3 | 84.2 | 71.4 |

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

| (in thousands) | Year ended December 31, | | |
|----------------------------------|-------------------------|------------------|------------------|
| | 2009 | 2008 | 2007 |
| CASUALTY | | | |
| General liability | \$115,439 | \$140,891 | \$167,876 |
| Commercial and personal umbrella | 62,388 | 65,091 | 66,281 |
| Commercial transportation | 42,185 | 46,710 | 49,119 |
| Specialty program business | 21,577 | 38,340 | 38,510 |
| Executive products | 15,553 | 13,846 | 12,029 |
| Other | 7,879 | 8,603 | 9,587 |
| Total | \$265,021 | \$313,481 | \$343,402 |
| PROPERTY | | | |
| Commercial property | \$ 81,828 | \$ 85,271 | \$ 92,634 |
| Marine | 52,470 | 48,166 | 32,868 |
| Other property | 21,005 | 13,426 | 12,865 |
| Total | \$155,303 | \$146,863 | \$138,367 |
| SURETY | | | |
| | \$ 71,637 | \$ 68,420 | \$ 62,709 |
| Grand total | \$491,961 | \$528,764 | \$544,478 |

Casualty

Casualty gross premiums written of \$333.1 million were down 17 percent in 2009 following a decline of 13 percent in 2008 and 9 percent decline in 2007. Premiums declined on all mature coverages, due to the soft pricing environment and weak economy. General liability, our largest product in this segment, posted gross premiums written of \$116.0 million, down 17 percent from 2008 and 34 percent from 2007. Rates are down 5 percent in 2009, following declines of 12 percent in 2008 and 2007. In addition, nearly half of the general liability book is construction-related. The significant reduction in construction activity, due to the weak economy, and continued rate deterioration has reduced premiums and exposures. While rates have deteriorated, this coverage continued to sustain profitable results. Commercial umbrella, personal umbrella and transportation also sustained declines in gross premiums written in 2009, down 24 percent, 3 percent and 9 percent, respectively, due to continued rate and exposure declines. The weak economy has resulted in umbrella insureds forgoing the purchase of excess limits in some instances and reducing limits in others. For transportation, miles driven and trucking revenues are down, and insureds are buying less coverage. In addition to the impact of the economy and soft pricing, there were targeted reductions in premiums for other casualty coverages. Gross premiums written for specialty program business declined \$34.4 million, or 75 percent, in 2009. Adverse loss experience on specialty programs resulted in our re-underwriting this business, including exiting certain unprofitable programs and scaling back others. In addition, our deductible buy-back coverage was discontinued in 2008. Despite competitive pressures in the casualty segment, we remained disciplined in writing only those accounts that we believe will provide adequate returns. The soft marketplace is likely to continue to challenge our ability to grow premium in this segment in 2010.

Underwriting income for the casualty segment was \$51.5 million in 2009, compared to \$46.5 million in 2008 and \$101.9 million in 2007. These results translated into combined ratios of 80.6, 85.2 and 70.3, respectively. Favorable development on prior accident years' loss reserves totaled \$65.5 million, \$50.6 million and \$87.4 million, respectively, for 2009, 2008 and 2007. This favorable emergence was concentrated in accident years 2003 through 2008, with the more recent years representing a larger portion of the release. In each of these years, actuarial studies indicated that cumulative experience attributable to some casualty coverages for mature accident years was lower than the reserves booked, resulting in the release of reserves. The 2007 result was

further impacted by a detailed analysis of recent favorable loss trends and reserve risk factors. This review resulted in certain refinements to our reserving methodologies. This and the increased stability in our business in more recent years diminished the needed level of carried reserves above the actuarial point estimate. Over half of the favorable prior years' loss development recorded in 2007 was the result of this detailed assessment and resulting reductions to our booked reserves.

The segment's loss ratio was 46.3 in 2009 compared to 54.2 in 2008 and 39.6 in 2007. Each year benefited from favorable reserve development on prior accident years. Current accident year loss ratios, however, have increased. In establishing expected loss ratios for a current accident year, we reflect historical loss experience, historical and projected rate changes, and historical and projected loss cost inflation. While favorable loss trends have partially mitigated the impact, the continued decline in rates has resulted in increased loss ratio estimates on current accident years. The expense ratio for the casualty segment was 34.3 in 2009 compared to 31.0 in 2008 and 30.7 in 2007. The decline in net premiums earned has resulted in reduced leverage on acquisition and other insurance operating expenses.

Property

Gross premiums written in the property segment increased 3 percent in 2009 after posting a decline of 3 percent in 2008 and a decline of 9 percent in 2007. The increase in 2009 is largely the result of increased facultative reinsurance premium, which posted \$11.6 million in gross premiums written, compared to \$4.8 million in 2008. In addition, commercial property increased in 2009, as rates on catastrophe exposed business improved. Increased catastrophe rates enabled us to grow premiums while reducing exposures and improving geographic spread of risk. After declining due to two consecutive years (2007 and 2006) of benign hurricane activity, wind rates were up in excess of 20 percent in 2009. In addition, rates charged for earthquake coverage increased during 2009, and we focused on insuring risks that provided the best risk/reward trade off and on continuing to reduce our overall exposure to this peril. Earthquake exposure has declined in each of the last three years. While still providing an adequate return in 2008 and 2007, wind and earthquake rates were softer in those years, resulting in lower premiums written. Partially offsetting the increased production in facultative reinsurance and higher rates in commercial property, gross premiums written for marine declined 5 percent in 2009. This decline followed increased writings in both 2008 and 2007. Marine experienced adverse loss experience, particularly in hull (liability) and protection and indemnity coverages, and consequently, we took certain underwriting actions with respect to these coverages including non-renewing much of

the commercial tug and tow portfolio, where a majority of losses were originating, as well as re-underwriting excess liability coverages. As a result, gross premiums written declined in 2009.

Underwriting income was \$23.3 million in 2009, compared to income of \$15.8 million in 2008 and \$30.6 million in 2007. The segment's results translated into combined ratios of 85.0, 89.3 and 77.9, respectively for 2009, 2008 and 2007. Results for 2009 benefited from a benign catastrophe season and a low loss ratio on non-catastrophe exposed commercial fire business. Partially offsetting these factors, however, was unfavorable loss experience on current and prior accident years for marine. This development is primarily attributable to the commercial tug and towing class that impacts both hull and protection and indemnity coverages. As discussed previously, underwriting action, including the non-renewal of unprofitable accounts, was initiated in late 2008 and continued in 2009. As a direct result of poor underwriting results, reserves were increased on current and prior accident years. During 2009, marine experienced \$11.4 million of adverse development (reserve additions) on prior accident years, with the 2008 accident year receiving the largest increase. On a positive note, reserves for the 2008 hurricanes and run-off construction business have continued to trend favorably, resulting in reserve take-downs. In 2008, underwriting income included \$22.8 million in losses associated with Hurricanes Gustav and Ike, which more than offset the improved loss performance of non-wind commercial fire accounts during that year. Results for 2007 benefited from a benign hurricane season, a decline in losses from tornadoes and hail storms, as well as lower frequency and severity of commercial fire losses.

Surety

Gross premiums written for surety have increased in each of the last three years and net premiums earned followed suit, improving by 5 percent in 2009, 9 percent in 2008 and 6 percent in 2007. Investment in capacity, through underwriter additions and geographic expansion, fueled premium growth in contract and miscellaneous surety. In addition, we established a new fidelity division in late 2008 focusing on fidelity and crime coverage for commercial insureds and select financial institutions. While these investments resulted in increased acquisition costs, loss ratios remained low, resulting in positive underwriting income.

Underwriting income totaled \$12.0 million in 2009, compared to \$20.7 million in 2008 and \$23.3 million in 2007. After doubling in 2007, underwriting income declined modestly in 2008 and declined further in 2009, but represented excellent results for this segment. Premium growth was achieved while maintaining underwriting discipline. Positive results on the current accident year were

amplified by favorable development on prior accident years. In 2009, favorable development on prior accident years' loss reserves totaled \$4.5 million, compared to \$5.1 million in 2008 and \$11.1 million in 2007. Given the short-tail nature of surety losses, the majority of favorable reserve development occurs in the most recent accident years. Additionally, for 2007, increased favorable development was the result of our actuarial risk reassessment and reflection of significantly lower reserve risk, following continued favorable loss trends and further progress on the Commercial Money Center litigation, which was settled during 2008.

NET INVESTMENT INCOME AND REALIZED INVESTMENT GAINS

During 2009, net investment income decreased by 15 percent due to changes in asset allocation, a falling interest rate environment as well as dividend reductions. The average annual yields on our investments were as follows for 2009, 2008 and 2007:

| | 2009 | 2008 | 2007 |
|----------------------------|-------|-------|-------|
| PRETAX YIELD | | | |
| Taxable (on book value) | 5.03% | 5.58% | 5.46% |
| Tax-exempt (on book value) | 3.79% | 3.99% | 4.07% |
| Equities (on fair value) | 2.72% | 3.81% | 3.03% |
| AFTER-TAX YIELD | | | |
| Taxable (on book value) | 3.27% | 3.63% | 3.55% |
| Tax-exempt (on book value) | 3.59% | 3.78% | 3.85% |
| Equities (on fair value) | 2.33% | 3.27% | 2.60% |

The after-tax yield reflects the different tax rates applicable to each category of investment. Our taxable fixed income securities are subject to our corporate tax rate of 35 percent, our tax-exempt municipal securities are subject to a tax rate of 5.3 percent and our dividend income is generally subject to a tax rate of 14.2 percent. During 2009, the average after-tax yield on the fixed income portfolio declined to 3.4 percent from the 3.7 percent yield in 2008. During the year, we focused on purchasing high-quality fixed income investments, primarily in the 5 to 15 year range of the yield curve.

The fixed income portfolio increased by \$211.3 million during the year. This portfolio had net realized gains of \$6.7 million and a tax-adjusted total return on a mark-to-market basis of 8.8 percent. Our equity portfolio decreased by \$24.1 million during 2009 due to sales associated with changes in asset allocation, to \$262.7 million. As of December 31, 2009, our equity portfolio had net unrealized gains of \$85.0 million. The total return for the year on the equity portfolio was 18.5 percent.

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

| (in thousands) | Average Invested Assets ⁽¹⁾ | Net Investment Income ⁽²⁾⁽³⁾ | Net Realized Gains (Losses) ⁽³⁾ | Change in Unrealized Appreciation ⁽³⁾⁽⁴⁾ | Annualized Return on Avg. Invested Assets | Tax Equivalent Annualized Return on Avg. Invested Assets |
|----------------|--|---|--|---|---|--|
| 2005 | 1,633,755 | 61,641 | 16,354 | (35,788) | 2.6% | 3.3% |
| 2006 | 1,763,016 | 71,325 | 31,045 | 34,395 | 7.8% | 8.6% |
| 2007 | 1,834,009 | 78,901 | 28,966 | (14,650) | 5.1% | 5.9% |
| 2008 | 1,749,303 | 78,986 | (46,738) | (123,607) | -5.2% | -4.5% |
| 2009 | 1,755,665 | 67,346 | (12,755) | 95,281 | 8.5% | 9.0% |
| 5-yr Avg. | \$1,747,150 | \$71,640 | \$3,374 | \$(8,874) | 3.8% | 4.5% |

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

⁽²⁾ Investment income, net of investment expenses.

⁽³⁾ Before income taxes.

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

We realized \$12.8 million in net investment losses in 2009 relating mostly to OTTI. Included in this number is \$19.4 million in net realized losses in the equity portfolio, \$6.7 million in net realized gains in the fixed income portfolio, and other realized losses of \$0.1 million. In 2008, we realized \$46.7 million in net investment losses. We realized \$38.7 million in net realized losses in the equity portfolio, \$8.2 million in net realized losses in the fixed income portfolio, and other realized gains of \$0.2 million. In 2007, we realized net investment gains of \$29.0 million. Included in this number are net realized gains of \$29.9 million in the equity portfolio, net realized losses of \$1.0 million in the fixed income portfolio, and other realized gains of \$0.1 million.

We regularly evaluate the quality of our investment portfolio. When we determine that a specific security has suffered an other-than-temporary decline in value, the investment's value is adjusted by reclassifying the decline from unrealized to realized losses. This has no impact on shareholders' equity. During 2009, we recognized OTTI losses of \$45.3 million. This total includes \$40.7 million in equity and \$4.6 million in fixed income securities. Of the total charge, \$38.6 million came during the first quarter as the financial markets continued to deteriorate. Less than \$0.1 million was impaired during the second half of 2009. Pursuant to the adoption of ASC 320-10-65, all impairments of fixed income securities were recorded through earnings due to our intent to sell the securities. In 2008, we recognized OTTI losses of \$76.2 million. There were no losses associated with the OTTI of securities in 2007.

The following table is used as part of our impairment analysis and illustrates the total value of securities that were in an unrealized loss position as of December 31, 2009. This table segregates the securities based on type, noting the fair value, cost (or amortized cost) and unrealized

loss on each category of investment as well as in total. The table further classifies the securities based on the length of time they have been in an unrealized loss position.

| (in thousands) | <12 Mos. | 12 Mos. & greater | Total |
|--|-----------|-------------------|-----------|
| U.S. Government | | | |
| Fair value | \$ — | \$ — | \$ — |
| Cost or amortized cost | — | — | — |
| Unrealized loss | — | — | — |
| Non-U.S. Government | | | |
| Fair value | \$ 934 | \$ — | \$ 934 |
| Cost or amortized cost | 945 | — | 945 |
| Unrealized loss | (11) | — | (11) |
| U.S. Agency | | | |
| Fair value | \$248,507 | \$ — | \$248,507 |
| Cost or amortized cost | 253,027 | — | 253,027 |
| Unrealized loss | (4,520) | — | (4,520) |
| Mortgage Backed | | | |
| Fair value | \$ 24,931 | \$ — | \$ 24,931 |
| Cost or amortized cost | 25,302 | — | 25,302 |
| Unrealized loss | (371) | — | (371) |
| ABS/CMO* | | | |
| Fair value | \$ 4,587 | \$ 3,255 | \$ 7,842 |
| Cost or amortized cost | 4,640 | 3,331 | 7,971 |
| Unrealized loss | (53) | (76) | (129) |
| Corporate | | | |
| Fair value | \$ 68,436 | \$ 8,420 | \$ 76,856 |
| Cost or amortized cost | 69,541 | 8,969 | 78,510 |
| Unrealized loss | (1,105) | (549) | (1,654) |
| States, political subdivisions and revenues | | | |
| Fair value | \$ 72,922 | \$ 7,028 | \$ 79,950 |
| Cost or amortized cost | 73,531 | 7,174 | 80,705 |
| Unrealized loss | (609) | (146) | (755) |
| Subtotal, debt securities | | | |
| Fair value | \$420,317 | \$18,703 | \$439,020 |
| Cost or amortized cost | 426,986 | 19,474 | 446,460 |
| Unrealized loss | (6,669) | (771) | (7,440) |
| Common stock | | | |
| Fair value | \$ 11,720 | \$ 2,468 | \$ 14,188 |
| Cost or amortized cost | 12,019 | 2,624 | 14,643 |
| Unrealized loss | (299) | (156) | (455) |
| Preferred stock | | | |
| Fair value | \$ — | \$ — | \$ — |
| Cost or amortized cost | — | — | — |
| Unrealized loss | — | — | — |
| Total | | | |
| Fair value | \$432,037 | \$21,171 | \$453,208 |
| Cost or amortized cost | 439,005 | 22,098 | 461,103 |
| Unrealized loss | (6,968) | (927) | (7,895) |

*Asset-backed & collateralized mortgage obligations

The following table is also used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of December 31, 2009, including fair value, cost basis and unrealized gains and losses.

| (in thousands) | Cost Basis | 12/31/09 Fair Value | Net Unrealized Gains/Losses | | Net | Unrealized Gain/Loss% ⁽¹⁾ |
|------------------------|------------------|---------------------|-----------------------------|----------------|-----------------|--------------------------------------|
| Common stock: | | | | | | |
| Consumer discretionary | \$ 15,188 | \$ 17,973 | \$ 2,941 | \$ (156) | \$ 2,785 | 18.3% |
| Consumer staples | 13,459 | 26,805 | 13,346 | — | 13,346 | 99.2% |
| Energy | 11,119 | 23,301 | 12,182 | — | 12,182 | 109.6% |
| Financials | 18,355 | 24,548 | 6,193 | — | 6,193 | 33.7% |
| Healthcare | 7,800 | 16,398 | 8,814 | (216) | 8,598 | 110.2% |
| Industrials | 18,345 | 28,894 | 10,549 | — | 10,549 | 57.5% |
| Information technology | 17,996 | 28,326 | 10,330 | — | 10,330 | 57.4% |
| Materials | 5,313 | 6,345 | 1,032 | — | 1,032 | 19.4% |
| Telecommunications | 4,409 | 8,777 | 4,368 | — | 4,368 | 99.1% |
| Utilities | 35,022 | 47,032 | 12,093 | (83) | 12,010 | 34.3% |
| ETFs | 30,675 | 34,294 | 3,619 | — | 3,619 | 11.8% |
| Total | \$177,681 | \$262,693 | \$85,467 | \$(455) | \$85,012 | 47.8% |

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

As of December 31, 2009, we held five securities in our equity portfolio that were in unrealized loss positions. The total unrealized loss on these securities was \$0.5 million. With respect to both the significance and duration of the unrealized loss positions, we have no equity securities in an unrealized loss of greater than 20 percent for more than six consecutive months.

The fixed income portfolio contained 135 positions at an unrealized loss as of December 31, 2009. Of these 135 securities, 12 have been in an unrealized loss position for 12 consecutive months or longer and these collectively represent \$0.8 million in unrealized losses. We have the ability and intent to hold these securities to maturity. In addition, we continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. We consider price declines of securities in our OTTI 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.

Key factors that we consider in the evaluation of credit quality include:

- Changes in technology that may impair the earnings potential of the investment,
- The discontinuance of a segment of the business that may affect the future earnings potential,
- Reduction or elimination of dividends,

- Specific concerns related to the issuer's industry or geographic area of operation,
- Significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
- Downgrade in credit quality by a major rating agency.

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

INVESTMENTS

We maintain a diversified investment portfolio which has had an 80 percent fixed income and 20 percent equity target over the last five years. During the credit crises that ensued in late 2008 and early 2009, we reduced our target equity allocation to 15 percent to reduce the volatility of our portfolio. We continually monitor economic conditions, our capital position and the insurance market to determine our equity allocation. As of December 31, 2009, the portfolio had a fair value of \$1.9 billion, up from \$1.7 billion at the end of 2008. The increase in the value of the investment portfolio was the result of general market conditions improving significantly.

As of December 31, 2009, our investment portfolio had the following asset allocation breakdown:

PORTFOLIO ALLOCATION

| (in thousands) | Cost or Amortized Cost | Fair Value | Unrealized Gain/(Loss) | % of Total Fair Value | Quality |
|------------------------|------------------------|-------------|------------------------|-----------------------|---------|
| Agencies | \$ 335,618 | \$ 332,680 | \$ (2,938) | 18.0% | AAA |
| Corporates | 423,147 | 438,392 | 15,245 | 23.7% | A |
| Mortgage-backed | 234,952 | 241,602 | 6,650 | 13.1% | AAA |
| ABS/CMO* | 49,437 | 50,833 | 1,396 | 2.7% | AAA |
| Treasuries** | 6,542 | 6,763 | 221 | 0.4% | AAA |
| Munis | 402,389 | 413,208 | 10,819 | 22.3% | AA |
| Total fixed income | \$1,452,085 | \$1,483,478 | \$ 31,393 | 80.2% | AA |
| Equities | \$ 177,681 | \$ 262,693 | \$ 85,012 | 14.2% | |
| Short-term investments | \$ 104,462 | \$ 104,462 | — | 5.6% | |
| Total portfolio | \$1,734,228 | \$1,850,633 | \$116,405 | 100.0% | |

*Asset-backed and collateralized mortgage obligations

**Includes U.S. and Non-U.S. Government

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

Our fixed income portfolio comprised 80 percent of our total 2009 portfolio, versus 77 percent of the total at December 31, 2008, and 75 percent of the total as of December 31, 2007. As of December 31, 2009, the carrying value of our fixed income portfolio consisted of 48 percent AAA-rated securities, 22 percent AA-rated securities, 22 percent A-rated securities and 8 percent BBB-rated securities.

In selecting the maturity of securities in which we invest, we consider the relationship between the duration of our fixed income investments and the duration of our liabilities, including the expected ultimate payout patterns of our reserves. We believe that both liquidity and interest rate risk can be minimized by such asset/liability management. As of December 31, 2009, our fixed income portfolio's duration was 4.9 years and remained diversified. During 2009, the total return on our bond portfolio on a tax-equivalent, mark-to-market basis was 8.8 percent.

In addition, at December 31, 2009, our equity portfolio had a fair value of \$262.7 million, all of which is classified as available-for-sale and is also a source of liquidity. Our equity portfolio comprised 14 percent of our total 2009 portfolio, versus 17 percent at December 31, 2008. We maintain a diversified group of equity securities. The securities within the equity portfolio remain primarily invested in large-cap issues with an overall dividend yield that exceeds the S&P 500. In addition, we have investments in three exchange traded funds. The strategy remains one of value investing, with security selection taking precedence over market timing. A buy-and-hold strategy is used, minimizing both transactional costs and taxes. During 2009, the total return on our equity portfolio on a mark-to-market basis was 18.5 percent, compared to the S&P return of 26.5 percent.

Our investment portfolio does not have any direct exposure to credit default swaps or derivatives. We completely exited our securities lending program as of June 30, 2009.

FIXED INCOME PORTFOLIO

As of December 31, 2009, our fixed income portfolio had the following rating distributions:

| FAIR VALUE (in thousands) | AAA | AA | A | BBB | BB or Below | Fair Value |
|---|------------------|------------------|------------------|------------------|----------------|--------------------|
| Bonds: | | | | | | |
| Corporate – financial | \$ – | \$ 22,125 | \$ 85,720 | \$ 6,236 | \$ – | \$ 114,081 |
| All other corporate | 4,279 | 24,814 | 151,893 | 93,624 | 3,935 | 278,545 |
| Financials – private placements | – | 5,216 | 12,415 | 11,219 | – | 28,850 |
| All other corporates – private placements | – | – | 12,871 | 4,045 | – | 16,916 |
| U.S. govt. agency (GSE) | 338,246 | 263 | – | – | – | 338,509 |
| Non-U.S. govt. agency | 934 | – | – | – | – | 934 |
| Tax-Exempt municipal securities | 70,199 | 272,568 | 61,582 | 8,859 | – | 413,208 |
| Structured: | | | | | | |
| GSE – RMBS | \$241,602 | \$ – | \$ – | \$ – | \$ – | \$ 241,602 |
| Non-GSE RMBS – prime | – | – | – | – | – | – |
| Non-GSE RMBS – Alt A | – | – | – | – | – | – |
| Non-GSE RMBS – subprime | – | – | – | – | – | – |
| ABS – home equity | – | – | – | – | – | – |
| ABS – credit cards | – | – | – | – | – | – |
| ABS – auto loans | – | – | – | – | – | – |
| All other ABS | 12,645 | – | – | – | – | 12,645 |
| CMBS | 37,990 | 91 | 107 | – | – | 38,188 |
| Total | \$705,895 | \$325,077 | \$324,588 | \$123,983 | \$3,935 | \$1,483,478 |

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

We have two securities that are not rated with a total fair value of \$4.1 million.

Mortgage-Backed, Commercial Mortgage-Backed, and Asset-Backed Securities

Our mortgage-backed securities (MBS) portfolio is comprised of residential MBS investments. As of December 31, 2009, MBS investments totaled \$241.6 million (16 percent) of the fixed income portfolio compared to \$172.6 million (14 percent) as of December 31, 2008.

We believe MBS investments add diversification, liquidity, credit quality and additional yield to our portfolio. Our objective for the MBS portfolio is to provide reasonable cash flow stability and increased yield. The MBS portfolio includes collateralized mortgage obligations (CMOs) and mortgage-backed pass-through securities. A mortgage pass-through is a security consisting of a pool of residential mortgage loans. All payments of principal and interest are passed through to investors each month. A CMO is a mortgage-backed security

with a fixed maturity. This can eliminate the risks associated with prepayment because each security is divided into maturity classes that are paid off in order. Our MBS portfolio does not include interest-only securities, principal-only securities or other MBS investments which may exhibit extreme market volatility.

Prepayment/extension risk is an inherent risk of holding MBSs. However, the degree of prepayment/extension risk varies by the type of MBS held. We reduce our portfolio's exposure to prepayment/extension by including less volatile types of MBSs. As of December 31, 2009, \$28.3 million (12 percent) of the MBS portfolio was invested in planned amortization class CMOs (PACs) compared to \$0.1 million (less than 1 percent) as of December 31, 2008. PACs are securities whose cash flows are designed to remain constant in a variety of mortgage prepayment environments. Most of the portfolio's non-PAC MBSs possess varying degrees of cash flow structure and prepayment/extension risk. The MBS portfolio contained 87 percent of pure pass-throughs as of December 31, 2009, compared to 78 percent as of December 31, 2008. As of December 31, 2009, all of the securities in our MBS portfolio were rated AAA. In addition, these securities were mortgage-backed securities issued by the Governmental National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC). Government Sponsored Enterprises (GSEs), such as GNMA, FNMA and FHLMC, facilitate liquidity in the mortgage

market by purchasing conforming mortgages from lenders, securitizing them and selling them into the secondary market.

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

| MBS | | | | |
|----------------------------|--------|------------------|------------------|-------------|
| (in thousands) | Rating | Amortized Cost | Fair Value | % of Total |
| 2009 | | | | |
| Planned amortization class | AAA | \$ 27,068 | \$ 28,261 | 12% |
| Sequential | AAA | 3,000 | 3,131 | 1% |
| Pass-throughs | AAA | 204,884 | 210,210 | 87% |
| Total | | \$234,952 | \$241,602 | 100% |
| 2008 | | | | |
| Planned amortization class | AAA | \$ 62 | \$ 62 | 0% |
| Sequential | AAA | 37,846 | 38,538 | 22% |
| Pass-throughs | AAA | 130,343 | 133,962 | 78% |
| Total | | \$168,251 | \$172,562 | 100% |

An asset-backed security (ABS) is a type of debt security that is based on pools of assets or collateralized by the cash flows from a specific pool of underlying assets. These asset pools can include items such as credit card payments, auto loans and mortgages. The majority of our ABS portfolio is comprised of rate reduction utility bonds. As of December 31, 2009, ABS/CMBS (commercial mortgage-backed securities) investments were \$50.8 million (3 percent) of the fixed income portfolio, compared to \$64.8 million (5 percent) as of December 31, 2008. CMBS made up \$38.2 million (75 percent) of the ABS/CMBS portfolio compared to \$43.6 million (67 percent) at December 31, 2008. Nearly all of the CMBS portfolio was rated AAA as of December 31, 2009.

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

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

| ABS/CMBS | | | | |
|-----------------|--------|-----------------|-----------------|-------------|
| (in thousands) | Rating | Amortized Cost | Fair Value | % of Total |
| 2009 | | | | |
| CMBS | AAA | \$37,585 | \$38,188 | 75% |
| Home equity | AAA | — | — | — |
| Auto | AAA | — | — | — |
| Equipment | AAA | — | — | — |
| Franchise | AAA | — | — | — |
| Utility | AAA | 11,852 | 12,645 | 25% |
| Credit card | AAA | — | — | — |
| Total | | \$49,437 | \$50,833 | 100% |
| 2008 | | | | |
| CMBS | AAA | \$49,527 | \$43,635 | 67% |
| Home equity | AAA | 2,702 | 2,529 | 4% |
| Auto | AAA | 3,903 | 3,799 | 6% |
| Equipment | AAA | 1,768 | 1,774 | 3% |
| Franchise | AAA | — | — | — |
| Utility | AAA | 12,860 | 12,765 | 19% |
| Credit card | AAA | 361 | 339 | 1% |
| Total | | \$71,121 | \$64,841 | 100% |

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

All of our collateralized securities have improved significantly in 2009. Unrealized losses were \$0.5 million as of December 31, 2009 compared to \$6.0 million at the end of last year. All carry the highest credit rating by one or more major rating agency.

The following table summarizes the distribution by collateral classification and rating of our subprime securities as of December 31, 2009 and 2008:

| SUBPRIME | | | | |
|-----------------|--------|----------------|----------------|-------------|
| (in thousands) | Rating | Amortized Cost | Fair Value | % of Total |
| 2009 | | | | |
| Home equity | | — | — | — |
| Total | | — | — | — |
| 2008 | | | | |
| Home equity | AAA | \$2,702 | \$2,529 | 100% |
| Total | | \$2,702 | \$2,529 | 100% |

In 2009, we eliminated our exposures to subprime mortgages. We do not own any subprime mortgages, credit card asset-backed securities, or auto loan asset-backed securities as of December 31, 2009.

Municipal Fixed Income Securities

We have a significant allocation to municipal fixed income securities. As of December 31, 2009, municipal bonds totaled \$413.2 million (28 percent) of our fixed income portfolio as compared to \$453.9 million (36 percent) as of December 31, 2008.

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

Our municipal fixed income portfolio is comprised of general obligation (GO) and revenue securities. The revenue sources include sectors such as sewer and water, public improvement, school, transportation, colleges and universities.

As of December 31, 2009, approximately 58 percent of the municipal fixed income securities in the investment portfolio were GO and the remaining 42 percent were revenue fixed income. Eighty-three percent of our municipal fixed income securities were rated AA or better, while 98 percent were rated A or better. Our municipal fixed income portfolio has high credit quality.

The amortized cost and fair value of fixed income securities at December 31, 2009, by contractual maturity, are shown as follows:

| TOTAL FIXED INCOME (in thousands) | Amortized Cost | Fair Value |
|---|--------------------|--------------------|
| Due in one year or less | \$ 25,809 | \$ 26,162 |
| Due after one year through five years | 259,071 | 271,206 |
| Due after five years through 10 years | 540,819 | 551,803 |
| Due after 10 years | 341,997 | 341,872 |
| Mtge/ABS/CMO* | 284,389 | 292,435 |
| Total | \$1,452,085 | \$1,483,478 |

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

Corporate Debt Securities

As of December 31, 2009, our corporate debt portfolio totaled \$438.4 million (30 percent) of the fixed income portfolio compared to \$272.9 million (21 percent) as of December 31, 2008. The corporate debt portfolio has an overall quality rating of single A, diversified amongst 151 issuers.

The following table illustrates our corporate debt exposure to the financial and non-financial sectors as of December 31, 2009, including fair value, cost basis and unrealized gains and losses:

| (in thousands) | Amortized Cost | Fair Value | Gross Unrealized Gains | Gross Unrealized Losses |
|--|------------------|------------------|------------------------|-------------------------|
| Bonds: | | | | |
| Corporate - financial | \$111,786 | \$114,081 | \$ 2,958 | \$ (663) |
| All other corporate | 266,844 | 278,545 | 12,556 | (855) |
| Financials - private placements | 28,233 | 28,850 | 730 | (113) |
| All other corporate - private placements | 16,284 | 16,916 | 657 | (25) |
| Total | \$423,147 | \$438,392 | \$16,901 | \$(1,656) |

Corporate debt securities improved in 2009 as the global credit crisis stabilized. We believe corporate debt investments add diversification and additional yield to our portfolio. With our high quality, diversified portfolio, the corporate debt investments will continue to be a significant part of our investment program and we believe it is probable that the securities in our portfolio will continue to receive contractual payments in the form of principal and interest.

EQUITY SECURITIES

As of December 31, 2009, our equity portfolio totaled \$262.7 million (14 percent) of the investment portfolio compared to \$286.8 million (17 percent) as of December 31, 2008. The securities within the equity portfolio remain primarily invested in large-cap issues with a focus on dividend income. In addition, we have investments in three exchange traded funds. In 2009, we recorded impairment losses of \$40.7 million on our equity securities. The impairments were the result of our belief that the securities were not likely to recover in a reasonable period of time.

The following table illustrates the distribution by sector of our equity portfolio as of December 31, 2009, including fair value, cost basis and unrealized gains and losses:

| (in thousands) | Cost Basis | 12/31/2009 Fair Value | % of Total Fair Value | Net Unrealized Gain/Loss |
|------------------------|------------------|-----------------------|-----------------------|--------------------------|
| Common stock: | | | | |
| Consumer discretionary | \$ 15,188 | \$ 17,973 | 6.8% | \$ 2,785 |
| Consumer staples | 13,459 | 26,805 | 10.2% | 13,346 |
| Energy | 11,119 | 23,301 | 8.9% | 12,182 |
| Financials | 18,355 | 24,548 | 9.4% | 6,193 |
| Healthcare | 7,800 | 16,398 | 6.2% | 8,598 |
| Industrials | 18,345 | 28,894 | 11.0% | 10,549 |
| Information technology | 17,996 | 28,326 | 10.8% | 10,330 |
| Materials | 5,313 | 6,345 | 2.4% | 1,032 |
| Telecommunications | 4,409 | 8,777 | 3.3% | 4,368 |
| Utilities | 35,022 | 47,032 | 17.9% | 12,010 |
| ETFs | 30,675 | 34,294 | 13.1% | 3,619 |
| Total | \$177,681 | \$262,693 | 100.0% | \$85,012 |

Common Stocks

As of December 31, 2009, our common stock portfolio totaled \$228.4 million (87 percent) of the equity portfolio compared to \$201.5 million (70 percent) as of December 31, 2008. The increase in value of our common stock portfolio in 2009 was primarily due to the strong returns in the asset class as well as re-allocating funds from preferred stocks and a high-yield municipal bond fund.

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

Exchange Traded Fund Securities (ETFs)

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

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

In 2009, we added one exchange traded fund to our equity portfolio, while eliminating two others. As of December 31, 2009, our ETF investment totaled \$34.3 million (13 percent) of the equity portfolio compared to \$40.1 million (14 percent) as of December 31, 2008. The ETF investments add diversification, liquidity and increased return potential to our portfolio. In 2009, the ETFs were the

best performing part of our equity portfolio, slightly trailing the overall market.

In 2009, we eliminated our preferred stock and high-yield municipal bond fund (\$11.9 million and \$33.3 million respectively at December 31, 2008). As a result of the financial crisis and the significant deterioration in the issuer's financial strength, we sold our preferred stocks and exited the asset class at a loss.

INTEREST AND GENERAL CORPORATE EXPENSE

Interest on debt declined in 2009 and 2008 as we paid off our short-term debt in 2008. We incur short-term debt primarily through the use of reverse repurchase transactions. The use and repayment of such agreements remains an investment decision, based on whether the allocation of available cash flow to purchase debt securities generates a greater amount of investment income than would be paid in interest expense. In 2007, we had expanded our use of this debt as yield spreads had widened. We paid off the reverse repurchase debt in 2008 as the credit markets experienced increased volatility. Decisions regarding future short-term debt management will be based on available cash flow and the interest rate environment.

In 2009, 2008 and 2007, we incurred \$6.0 million in interest on our long-term debt each year. Our long-term debt consists of \$100.0 million in senior notes that mature on January 15, 2014, and pay interest semi-annually at the rate of 5.95 percent.

As discussed previously, general corporate expenses tend to fluctuate relative to our executive compensation plan. Our compensation model measures comprehensive earnings against a minimum required return on our capital. Bonuses are earned as we generate earnings in excess of this required return. In 2009 and 2007, we generated comprehensive earnings significantly above the required return, resulting in increased bonuses accrued. In 2008, the actual return was below the required return resulting in no bonus earned on the current year and reductions to bonuses accrued but unpaid on prior years. Excluding the variable component tied to performance, other general corporate expenses have declined, as we focused efforts on reducing and eliminating nonessential expense.

INVESTEE EARNINGS

We maintain a 40 percent equity interest in Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality polarized sunglasses. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim. In 2009, we recorded \$5.1 million in earnings from this investment compared to \$4.8 million in 2008 and \$7.3 million in 2007. In 2009, sunglass sales were down 14 percent due to the global economic slowdown and ensuing effect on consumer discretionary spending. During 2009, Maui Jim focused on controlling and reducing expenses.

Operating expenses were down in 2009, but reflected a higher percentage of gross margins due to the fixed nature of certain expenses. Expense control efforts served to lessen the impact to earnings of the drop in sales. While sunglass sales had advanced 7 percent in 2008, costs associated with expansion efforts and foreign exchange losses affected earnings. In 2008, Maui Jim recorded \$6.3 million in foreign exchange losses, compared to gains of \$2.6 million in 2009 and \$0.5 million in 2007.

INCOME TAXES

Our effective tax rates were 29.1 percent, 26.2 percent and 30.9 percent for 2009, 2008 and 2007, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2009 was higher than 2008 due to an increase in underwriting income and a significant reduction in net realized losses. A 35.0 percent rate is applied to determine tax provisions for underwriting income, and to determine tax benefits in the event of realized investment losses.

Our net earnings also include equity in earnings of an unconsolidated investee, Maui Jim. This investee does not have a pattern of paying dividends. As a result, we record a deferred tax liability on these earnings at the corporate capital gains rate of 35 percent. In 2008, a \$1.1 million tax benefit was realized associated with a dividend declared and subsequently received from Maui Jim. The tax benefit results from applying the lower tax rate applicable to affiliated dividends (7 percent), as compared to the corporate capital gains tax rate (35 percent) on which previous tax estimates were based.

In addition, our pretax earnings in 2009 included \$24.3 million of investment income that is partially exempt from federal income tax, compared to \$30.3 million and \$29.8 million in 2008 and 2007, respectively. Partially offsetting tax expense in 2007 was a \$2.4 million tax benefit recorded in the third quarter to reflect the benefit expected to be realized upon the future payment of certain accrued compensation.

NET UNPAID LOSSES AND SETTLEMENT EXPENSES

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

The liability can be split into two parts: (1) case reserves representing estimates of losses and settlement expenses on known claims and (2) IBNR reserves representing

estimates of losses and settlement expenses on claims that have occurred but have not yet been reported to us. Our gross liability for both case and IBNR reserves is reduced by reinsurance balances recoverable on unpaid losses and settlement expenses to calculate our net reserve balance. This net reserve balance increased to \$810.1 million at December 31, 2009, from \$809.0 million as of December 31, 2008. This reflects incurred losses of \$203.4 million in 2009 offset by paid losses of \$202.3 million, compared to incurred losses of \$247.2 million offset by \$213.1 million paid in 2008. The overall small increase in our net loss and LAE reserves between 2009 and 2008 was due to a combination of factors. Loss and LAE ratios for the current accident year were higher due to continued soft market conditions. However, these were nearly offset by lower premiums earned in 2009 and favorable loss development of \$66.6 million from prior years.

Both the gross reserves (liability) and the reinsurance balances recoverable (asset) were reduced by the favorable reserve development. Total gross and ceded loss and LAE reserves dropped to \$1,146.5 million and \$336.4 million, respectively, at December 31, 2009, from \$1,159.3 million and \$350.3 million, respectively, at December 31, 2008.

MARKET RISK DISCLOSURE

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

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

INTEREST RATE RISK

Our primary exposure to interest rate risk is with our fixed income investment portfolio. Primary drivers to changes in interest rates include Federal Reserve policies, inflation assumptions, economic forecasts, liquidity, credit risk, etc. These risks can be mitigated through diversification, including insurer, issues, sectors, maturities, etc. Further, we deploy asset-liability management strategies to lower the impact of changes in interest rates on our balance sheet. Modified duration analysis is used to measure the sensitivity of the fixed income portfolio to changes in interest rates, providing a measure of price percentage volatility. We attempt to minimize interest rate risk by matching the duration of assets to that of liabilities.

Interest rate risk will also affect our income statement due to its impact on interest expense. As of December 31,

2009 and 2008, we had no short-term debt obligations. We also maintain a debt obligation that is long-term in nature. Our long-term debt carries a fixed interest rate. As such, our interest expense on this obligation is not subject to changes in interest rates. As this debt is not due until 2014, we will not assume risk in our ability to refinance this debt for several years.

EQUITY PRICE RISK

Equity price risk is the potential that we will incur economic loss due to the decline of common stock prices. Beta analysis is used to measure the sensitivity of our equity portfolio to changes in the value of the S&P 500 Index (an index representative of the broad equity market). Our current equity portfolio has a beta of 0.7 in comparison to the S&P 500. Our equity investment returns have been superior to the S&P 500 with less volatility. This low beta statistic reflects our long-term emphasis on maintaining a value oriented, dividend-driven investment philosophy for our equity portfolio.

SENSITIVITY ANALYSIS

The tables that follow detail information on the market risk exposure for our financial investments as of December 31, 2009. Listed on each table is the December 31, 2009, fair value for our assets and the expected pretax reduction in fair value given the stated hypothetical events. This sensitivity analysis assumes the composition of our assets remains constant over the period being measured and also assumes interest rate changes are reflected uniformly across the yield curve. For example, our ability to hold non-trading securities to maturity mitigates price fluctuation risks. For purposes of this disclosure, market-risk-sensitive instruments are divided into two categories: instruments held for trading purposes and those held for non-trading purposes. The examples given are not predictions of future market events, but rather illustrations of the effect such events may have on the fair value of our investment portfolio.

As of December 31, 2009, our fixed income portfolio had a fair value of \$1.5 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2009, levels with all other variables held constant. Such scenarios would result in decreases in the fair value of the fixed income portfolio of \$60.5 million and \$129.5 million, respectively. Due to our use of the held-to-maturity designation for a portion of the fixed income portfolio, the balance sheet impact of these scenarios would be lower.

As of December 31, 2009, our equity portfolio had a fair value of \$262.7 million. The base sensitivity analysis uses market scenarios of the S&P 500 Index declining both 10 percent and 20 percent. These scenarios would result

in approximate decreases in the equity fair value of \$22.6 million and \$45.3 million, respectively. As we designate all equities as available-for-sale, these fair value declines would impact our balance sheet.

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

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

| (in thousands) | 12/31/09 Fair Value | Interest Rate Risk | Equity Risk |
|------------------------------|------------------------|-----------------------|----------------|
| Held for trading purposes | | | |
| Fixed income securities | \$ 941 | \$ (38) | \$ – |
| Total trading | 941 | (38) | – |
| Held for nontrading purposes | | | |
| Fixed income securities | 1,482,537 | (60,475) | – |
| Equity securities | 262,693 | – | (22,642) |
| Total nontrading | 1,745,230 | (60,475) | (22,642) |
| Total trading & nontrading | \$1,746,171 | \$(60,513) | \$(22,642) |

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

| (in thousands) | 12/31/09 Fair Value | Interest Rate Risk | Equity Risk |
|------------------------------|------------------------|-----------------------|----------------|
| Held for trading purposes | | | |
| Fixed income securities | \$ 941 | \$ (73) | \$ – |
| Total trading | 941 | (73) | – |
| Held for nontrading purposes | | | |
| Fixed income securities | 1,482,537 | (129,515) | – |
| Equity securities | 262,693 | – | (45,283) |
| Total nontrading | 1,745,230 | (129,515) | (45,283) |
| Total trading & nontrading | \$1,746,171 | \$(129,588) | \$(45,283) |

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

| (in thousands) | 12/31/09 Fair Value | Interest Rate Risk | Equity Risk |
|------------------------------|------------------------|-----------------------|----------------|
| Held for trading purposes | | | |
| Fixed income securities | \$ 941 | \$ 40 | \$ – |
| Total trading | 941 | 40 | – |
| Held for nontrading purposes | | | |
| Fixed income securities | 1,482,537 | 46,422 | – |
| Equity securities | 262,693 | – | 22,642 |
| Total nontrading | 1,745,230 | 46,422 | 22,642 |
| Total trading & nontrading | \$1,746,171 | \$46,462 | \$22,642 |

TABLE 4

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

| (in thousands) | 12/31/09 Fair Value | Interest Rate Risk | Equity Risk |
|---------------------------------------|------------------------|-----------------------|------------------|
| Held for trading purposes | | | |
| Fixed income securities | \$ 941 | \$ 83 | \$ – |
| Total trading | 941 | 83 | – |
| Held for nontrading purposes | | | |
| Fixed income securities | 1,482,537 | 93,382 | – |
| Equity securities | 262,693 | – | 45,283 |
| Total nontrading | 1,745,230 | 93,382 | 45,283 |
| Total trading & nontrading | \$1,746,171 | \$93,465 | \$ 45,283 |

LIQUIDITY AND CAPITAL RESOURCES

OVERVIEW

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

| (in thousands) | 2009 | 2008 | 2007 |
|-----------------------------|------------------|-----------|-----------|
| Operating cash flows | \$127,759 | \$161,334 | \$127,023 |
| Investing cash flows (uses) | (96,099) | (69,474) | (6,718) |
| Financing cash flows (uses) | (31,660) | (91,860) | (120,305) |

We have posted strong operating cash flow in each of the last three years. Over the last 10 years, our operating cash flow has averaged \$145.9 million per year. Variations in operating cash flow between periods are largely driven by premium volume, claim payments, reinsurance and taxes. In addition, fluctuations in insurance operating expenses impact operating cash flow. The reduction in premium volume experienced in 2009 and 2008 was partially offset by a decline in paid losses. In 2008 and 2007, the majority of the operating cash flow generated was used in financing activities, funding the share repurchase program. The share repurchase program, suspended in the third quarter of 2008, was reinstated in the fourth quarter of 2009. During this time operating cash flow was allocated to investing activities.

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

We have entered into certain contractual obligations that require us to make recurring payments. The following table summarizes our contractual obligations as of December 31, 2009.

CONTRACTUAL OBLIGATIONS

| (in thousands) | Total | Payments due by period | | | |
|-----------------------------|--------------------|------------------------|------------------|------------------|---------------------|
| | | Less than 1 yr. | 1-3 yrs. | 3-5 yrs | More than 5 yrs. |
| Loss and settlement expense | \$1,146,460 | \$338,118 | \$418,866 | \$189,704 | \$199,772 |
| Long-term debt | 100,000 | – | – | 100,000 | – |
| Operating leases | 15,700 | 2,785 | 6,096 | 3,695 | 3,124 |
| Total | \$1,262,160 | \$340,903 | \$424,962 | \$293,399 | \$202,896 |

Loss and settlement expense reserves represent our best estimate of the ultimate cost of settling reported and unreported claims and related expenses. As discussed previously, the estimation of loss and loss expense reserves is based on various complex and subjective judgments. Actual losses and settlement expenses paid may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements. Similarly, the timing for payment of our estimated losses is not fixed and is not determinable on an individual or aggregate basis. The assumptions used in estimating the payments due by periods are based on our historical claims payment experience. Due to the uncertainty inherent in the process of estimating the timing of such payments, there is a risk that the amounts paid in any period can be significantly different than the amounts disclosed above. Amounts disclosed above are gross of anticipated amounts recoverable from reinsurers. Reinsurance balances recoverable on unpaid loss and settlement reserves are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not discharge us of our liability to policyholders. Amounts recoverable from reinsurers on unpaid loss and settlement reserves totaled \$336.4 million at December 31, 2009.

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

Our primary objective in managing our capital is to preserve and grow shareholders' equity and statutory surplus to improve our competitive position and allow for expansion of our insurance operations. Our insurance subsidiaries must maintain certain minimum capital levels in order to meet the requirements of the states in which we are regulated. Our insurance companies are also evaluated

by rating agencies that assign financial strength ratings that measure our ability to meet our obligations to policyholders over an extended period of time.

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

At December 31, 2009, we had short-term investments and other investments maturing within one year of approximately \$131.1 million and investments of \$404.7 million maturing within five years. We maintain a revolving line of credit with JP Morgan, which permits us to borrow up to an aggregate principal amount of \$25.0 million. Under certain conditions, the line may be increased up to an aggregate principal amount of \$50.0 million. The facility has a three-year term that expires on May 31, 2011. As of December 31, 2009, no amounts were outstanding on the revolving line of credit. We believe that cash generated by operations, cash generated by investments and cash available from financing activities will provide sufficient sources of liquidity to meet our anticipated needs over the next 12 to 24 months. We have generated positive operating cash flow for more than 20 consecutive years. In the most recent three years ended December 31, 2009, 2008 and 2007, our operating cash flow was \$127.8 million, \$161.3 million and \$127.0 million, respectively. The primary factor in our ability to generate positive operating cash flow is underwriting profitability.

OPERATING ACTIVITIES

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

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

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

receive to our reinsurers, and collect cash back when losses subject to our reinsurance coverage are paid.

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

INVESTING ACTIVITIES

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

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

We maintain a diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of December 31, 2009, our portfolio had a carrying value of \$1.9 billion. Invested assets at December 31, 2009, increased by \$193.7 million, or 12 percent, from December 31, 2008.

Our overall investment philosophy is designed to first protect policyholders by maintaining sufficient funds to meet corporate and policyholder obligations, then generate long-term growth in shareholders' equity. Because our existing and projected liabilities are sufficiently funded by the fixed income portfolio, we can improve returns by investing a portion of the surplus (within limits) in an equity portfolio. As of December 31, 2009, 32 percent of our shareholders' equity was invested in equities, as compared to 41 percent at December 31, 2008, and 51 percent at December 31, 2007.

We currently classify 14 percent of the securities in our fixed income portfolio as held-to-maturity, meaning they are carried at amortized cost and are intended to be held until their contractual maturity. Other portions of the fixed income portfolio are classified as available-for-sale (86 percent) or trading (less than 1 percent) and are carried at fair value. As of December 31, 2009, we maintained \$1.3 billion in fixed income securities within the available-for-sale and trading classifications. The available-for-sale portfolio provides an additional source of liquidity and can be used to address potential future changes in our asset/liability structure.

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

FINANCING ACTIVITIES

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

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

Our capital structure is comprised of equity and debt obligations. As of December 31, 2009, our capital structure consisted of \$100.0 million in 10-year maturity senior notes (long-term debt) and \$832.3 million of shareholders' equity. Debt outstanding comprised 11 percent of total capital as of December 31, 2009.

Our 135th consecutive dividend payment was declared in the first quarter of 2010 and will be paid on April 15, 2010, in the amount of \$0.28 per share. Since the inception of cash dividends in 1976, we have increased our annual dividend every year.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authorities of Illinois. The maximum dividend distribution in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Insurance Company (RLI Ins.) policyholder surplus as of December 31 of the preceding year or the net income of RLI Ins. for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend distribution that can be paid by RLI Ins. during 2010 without prior approval is \$78.4 million which represents 10 percent of policyholder surplus at December 31, 2009. The 12-month rolling dividend limitation in 2009, based on the above criteria, was \$67.8 million. In 2009, total cash dividends of \$40.0 million were paid by RLI Ins. These dividends were paid to provide additional capital to RLI Corp. and used for the share repurchase plan, shareholder dividends, interest on senior notes and general corporate expenses.

In October 2009, the stock repurchase program resumed after being temporarily suspended in the third quarter of 2008. For the year, we repurchased 386,084 shares at an average cost of \$51.22 per share (\$19.8 million). We have \$18.0 million of remaining capacity from the \$200 million stock repurchase program approved in 2007.

OUTLOOK FOR 2010

The insurance marketplace, and in particular the excess and surplus lines segment, is subject to cycles involving alternating periods of price increases ("hard markets") and price decreases ("soft markets"). It is expected that deteriorating industry results will have a moderating impact on the "soft market" that the industry has experienced for the last several years. However, we believe that the economic recession that intensified into 2009 will continue to put pressure on exposure bases, customer demand and insurance prices throughout most of 2010.

We have continued to invest in new products and underwriting talent throughout the soft market. We do expect to see premium growth in selected products in 2010 and underwriting income overall, absent any major catastrophe. Specific details regarding events in our insurance segments follow.

CASUALTY

We will maintain our income-focused strategy and look to broaden our production sources and product offerings as a means to holding our market position in this segment. We do not expect significant growth in this segment from our mature products during 2010, but we have made several investments in new products in 2009 and 2008 that we expect to gain traction. These new products include professional liability for architects and engineers, environmental liability, real estate investment trusts liability, railroad protective liability and cyber liability products. We also broadened eligibility for our personal umbrella product which will expand our market penetration in 2010.

We expect pricing to continue to remain stable during the year, but do not anticipate any strengthening in market pricing until the industry starts realizing adverse loss development. The lack of price increases and the threat of rising loss cost inflation will make it increasingly difficult to post underwriting income. However, we look to continue to exercise underwriting discipline, and select quality risks to outperform the marketplace in 2010.

PROPERTY

We believe property pricing will remain fairly flat in the year ahead. Earthquake and hurricane-exposed business will be under significant rate pressure due to the lack of event activity in 2009. Our marine business will be focused on re-underwriting and growing the products that have been profitable. In addition, we expect continued growth from our facultative reinsurance product that was started in 2008 and gained momentum in 2009. We also entered into two quota-share, assumed reinsurance transactions that will help diversify our property portfolio during 2010 including a South Carolina property treaty and a crop/hail and multi peril crop insurance treaty. We expect top line growth and

underwriting income in this segment for 2010, absent any major catastrophes.

SURETY

The surety segment, like our other segments, is expected to feel the pressure of the stressed economic environment. In 2009 and 2008, we expanded our geographic footprint in both miscellaneous and contract surety and added a fidelity team. We expect premium growth to continue in 2010. Our experienced underwriting staff coupled with our effective use of technology point to continued profitability in 2010.

INVESTMENTS

In 2010, capital market performance will depend upon the private sector's ability to replace the fiscal and monetary policies that have served to stabilize our markets. Given the high level of unemployment, excess capacity, tighter credit conditions, depressed housing prices, etc., we believe economic conditions remain fragile, and that growth in private sector spending will be difficult to achieve. In addition, the factors that drove markets higher during the decade of the 1990s including housing, leverage, deregulation, etc., are not likely to return in the near-term.

Interest rates remain low to historical levels but have increased from year end 2008 and we continue to weigh the risks of inflation and a rising interest rate environment.

Given the current economic conditions, we believe maintaining a high quality portfolio is prudent in this environment. In addition, our equity allocation remains at roughly 15 percent of our invested assets or roughly 32 percent of shareholders' equity. We will continue to weigh economic conditions in relation to our enterprise risk appetite in determining our asset allocation and risk tolerances within the investment portfolio.

PROSPECTIVE ACCOUNTING STANDARDS

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

STATE AND FEDERAL LEGISLATION

As an insurance holding company, we, as well as our insurance company subsidiaries, are subject to regulation by the states and territories in which the insurance subsidiaries are domiciled or transact business. Holding company registration in each insurer's state of domicile requires periodic reporting to the state regulatory authority of the financial, operational and management data of the insurers within the holding company system. All transactions within a holding company system affecting insurers must have fair and reasonable terms, and the insurer's policyholder

surplus following any transaction must be both reasonable in relation to its outstanding liabilities and adequate for its needs. Notice to regulators is required prior to the consummation of certain transactions affecting insurance company subsidiaries of the holding company system.

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

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

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

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

In addition, state-level changes to the insurance regulatory environment are frequent, including changes caused by legislation, regulations by the state insurance regulators and court rulings. State insurance regulators are members of the National Association of Insurance Commissioners (NAIC). The NAIC is a non-governmental regulatory support organization that seeks to promote uniformity and to enhance state regulation of insurance through various activities, initiatives and programs. Among other regulatory and insurance company support activities, the NAIC maintains a state insurance department accreditation program and proposes model laws, regulations and guidelines for approval by state legislatures and insurance regulators. To the extent such proposed model laws and regulations are adopted by states, they will apply to insurance carriers.

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

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

In addition to monitoring our existing regulatory obligations, we are also monitoring developments in the

following areas to determine the potential effect on our business and to comply with our legal obligations.

TROUBLED ASSET RELIEF PROGRAM

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

TERRORISM INSURANCE

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

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

SARBANES-OXLEY ACT OF 2002

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

The annual certification of our CEO with respect to compliance with the New York Stock Exchange corporate governance listing standards has been submitted to the New York Stock Exchange and the annual certifications of our CEO and CFO required by the Sarbanes-Oxley Act of 2002 with respect to our 2009 fiscal year have been filed with the SEC as an exhibit to our annual report on Form 10-K for 2009.

FEDERAL REGULATION OF INSURANCE

The U.S. insurance industry is not currently subject to any significant amount of federal regulation, and instead is regulated principally at the state level. However, federal insurance legislation of various types is regularly proposed in Congress. In 2009, several bills were introduced in Congress that would impact and regulate various aspects of the insurance industry. These proposed laws covered many areas, including providing an optional federal insurance charter, creation of a federal insurance information/oversight agency, streamlining state regulation of nonadmitted insurance, creating a systemic risk regulator and other proposals. However, none of the legislative proposals were enacted into law in 2009. In 2010, some of the 2009 proposed legislation may be proposed again in some form, and the federal government's reactions to the economic and financial market turmoil may produce some type of limited federal oversight or regulation of the insurance industry. However, we cannot predict whether any of such legislation will be proposed again or enacted, or whether any significant federal involvement in insurance regulation will be implemented in 2010 or the impact of any such laws or

regulation on our company. We will continue to monitor all federal insurance legislation.

CORPORATE COMPLIANCE

We have a code of conduct, corporate governance guidelines and compliance manual, which provide directors, officers and employees with guidance and requirements for complying with a variety of federal and state laws and company policies. Electronic versions of these documents, as well as the following documents will be available on our web site (www.rlicorp.com): 2009 annual report; 2010 proxy statement; 2009 annual report on Form 10-K; and charters of the executive resources, audit, finance and investment, strategy and nominating/corporate governance committees of our board of directors. Printed copies of these documents will be made available upon request without charge to any shareholder. We also maintain other policies and guidelines that support information security, ethical behavior and legal compliance.

FORWARD LOOKING STATEMENTS

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