

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 for certain markets that are underserved by the insurance and reinsurance 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 based on our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all market conditions and we have achieved this for 15 consecutive years, averaging an 87.6 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). A private equity investment, our minority ownership in Maui Jim, Inc. (Maui Jim), has 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 design professionals. 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 and treaty assumed reinsurance, including crop, 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 minimizing 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. Our assumed multi-peril crop and hail treaty reinsurance business covers revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects and disease. Significant aggregation of these losses are mitigated by the Federal Government reinsurance program that provides stop loss protection inuring to our benefit.

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. This line has historically produced marginally higher loss ratios than other surety lines during economic downturns.

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 risk selection and 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, we show certain statutory reporting information and other 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 consolidated 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 sheets, 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 used 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 payments 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, 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 from 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 significantly 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 it. The estimate reflects all of the current information available regarding the claim, the informed judgment of our professional claim personnel regarding the nature and value of the specific type of claim and our reserving practices. During the life cycle of a particular claim, as more information becomes available, we may 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, 2010, 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 premium earned. The IBNR percentage is determined based on historical reserve patterns and is updated periodically. In addition, for assumed reinsurance, consideration is given to information provided by the ceding company. 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 over a shorter period of time.

Our crop reinsurance business is unique and is subject to an inherently higher degree of estimation risk during interim periods. As a result, the interim reports and professional judgments of our ceding company's actuaries and crop business experts provide important information which assists us in estimating our carried reserves.

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, catastrophe model loss estimates based on our own exposures and industry loss estimates of the event. 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 to consider 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 exposure mix and price change and loss cost trends. The initial loss and ALAE ratios also reflect a 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 utilization of external data,
- Unique reinsurance features including those with aggregate stop-loss, reinstatement clauses, commutation provisions, or clash protection,
- Longer emergence patterns with exposures to latent unforeseen mass tort,
- Assumed reinsurance businesses where there is an extended reporting lag and/or a heavier utilization of ceding company data and claims and product expertise,
- 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 this analysis 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 such as our crop reinsurance business, 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 estimated losses relative to premium (loss ratios) by year into the analysis. The expected loss ratios are based on a review of historical loss performance, trends in frequency and severity and price level changes. The estimates are subject to judgment including consideration given to available internal and industry data, 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, 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 IBNR.

Our reserve processes include multiple standard actuarial methods for determining estimates of IBNR reserves. Other supplementary methodologies are incorporated as 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 weights to each based on the characteristics of the product being reviewed.

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, 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 processes affecting the timing of loss and LAE transactions,
- Regulatory and legal environment, and/or
- Economic environment.

Our actuaries engage in discussions with senior management, underwriting and the claim 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 uncertainty. Different experts will choose different assumptions, based on their individual backgrounds, professional experiences and areas of focus. Hence, the estimate selected by various qualified experts may differ significantly 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 ALAE analyses. Our actuaries make a recommendation to management in regards to booked reserves that reflect their analytical assessment and view of estimation risk. After discussion of these analyses and all relevant risk factors, the LRC determines whether the reserve

balances require adjustment. Resulting reserve balances have always fallen within our actuaries' reasonable range of estimates.

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. However, 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 ratios. 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 loss and LAE reserves may change as a result of 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, 2010.

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.

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

We determined the fair values of certain financial instruments based on the fair value hierarchy. GAAP guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value.

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 under 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 prior to maturity, 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 absence of intent to sell or requirement to sell fixed income securities prior to maturity. 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 reviewed on a segment basis and 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. See note 1 D to the consolidated financial statements for the discussion of a prospective accounting standard that will impact the accounting for costs associated with acquiring insurance policies in 2012.

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.

Periodically, management reviews our deferred tax positions to determine if it is more-likely-than-not that the assets will be realized. These 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. These estimates enter into the determination of the applicable tax rates and 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 consolidated financial statements.

RESULTS OF OPERATIONS

Consolidated revenue, as displayed in the table that follows, totaled \$583.4 million for 2010, compared to \$546.6 million in 2009 and \$561.0 million in 2008.

CONSOLIDATED REVENUE (in thousands)	Year ended December 31,		
	2010	2009	2008
Net premiums earned	\$493,382	\$491,961	\$528,764
Net investment income	66,799	67,346	78,986
Net realized investment gains (losses)	23,243	(12,755)	(46,738)
Total consolidated revenue	\$583,424	\$546,552	\$561,012

Revenue increased in 2010 after declining during 2009. Premiums earned from insurance operations improved slightly, while investment results were up markedly in 2010, following a decline in 2009, which was marked by turmoil in the financial markets. Net premiums earned advanced less than 1 percent in 2010, following a 7 percent decline in 2009. New product initiatives over the last several years, particularly in the property and surety segments, are beginning to gain scale and are serving to offset revenue declines in our casualty segment, which is most affected by the weak economy and continued rate softening. Investment income declined in 2010 and 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 a shift in asset mix toward higher-yielding securities (preferred stock and high-yield municipal bond fund). During 2010, we recorded net realized investment gains of \$23.2 million, due in large part to gains taken on the fixed income portfolio. During 2009, we had 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.

NET EARNINGS (in thousands)	Year ended December 31,		
	2010	2009	2008
Underwriting income	\$ 95,395	\$ 86,785	\$ 83,063
Net investment income	66,799	67,346	78,986
Net realized investment gains (losses)	23,243	(12,755)	(46,738)
Debt interest	(6,050)	(6,050)	(6,704)
Corporate expenses	(7,998)	(7,941)	(6,853)
Investee earnings	7,101	5,052	4,844
Pretax earnings	\$178,490	\$132,437	\$106,598
Income tax expense	(51,058)	(38,592)	(27,922)
Net earnings	\$127,432	\$ 93,845	\$ 78,676

Net earnings increased in 2010 and 2009, after declining in 2008, a year that was heavily influenced by net realized investment losses. Results for 2010 and 2009 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 \$95.4 million in 2010, compared to \$86.8 million in 2009 and \$83.1 million in 2008. 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. During 2009 and 2008, our premium revenue declined as a result of this discipline. During this time, we continued to invest in new product initiatives and geographic expansion to help offset the decline in existing products and to position ourselves for growth when the market improves. During 2010, earned premiums grew less than 1 percent as recent initiatives served to offset the decline of products most impacted by the market. Our underwriting 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 2010, we experienced \$83.2 million in favorable development on prior accident years' reserves, compared to favorable development of \$66.6 million in 2009 and \$62.3 million in 2008. Further discussion of reserve development can be found in note 6 to the consolidated financial statements.

Bonus and profit-sharing amounts earned by executives, managers and associates are predominately influenced by corporate performance, including operating earnings, combined ratio 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 manager and associate bonus targets. Bonus and profit sharing-related expenses, attributable to

operating earnings and combined ratio, were increased in 2010, 2009 and 2008 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 \$146.0 million in 2010 compared to \$156.1 million in 2009, and a comprehensive loss of \$1.9 million in 2008. As a result of comprehensive earnings and the improved return on capital in 2010 and 2009, bonus and profit sharing amounts were over \$10 million higher in these years compared to 2008. In 2008, the comprehensive loss resulted in the elimination of bonus and profit-sharing amounts earned based on return on capital, as well as reductions in amounts accrued but at-risk on prior years. Performance-related expenses impact policy acquisition, insurance operating and general corporate expenses line items in the financial statements. While performance-related expenses increased in 2010 and 2009, expense control efforts, which began in 2008, have continued and served to reduce the amount of non-performance related expenses.

Over the past several years, we have invested in our capacity to produce premium. We have expanded our geographic footprint of existing products by adding underwriters and entering new markets, and we have hired teams of underwriters to start new products. As a result, our policy acquisition costs, which include the expenses associated with this expansion, represent an increased percentage of net premiums earned. While policy acquisition costs as a percentage of net premiums earned declined to 32.0 percent in 2010 from 32.9 percent in 2009, they remain above the 30.9 percent reported for 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 2010 and 2009, after declining in 2008. Investee results for 2010 were reflective of increased sales volume. Results for 2009, while up from 2008, were affected by the economic uncertainty and ensuing effect on consumer discretionary spending.

RLI INSURANCE GROUP

In general, we have experienced continued softening in the marketplace over the last several years. Expansion efforts and new product initiatives, particularly in the property and surety segments, have, however, served to mitigate declines in our casualty segment. New product initiatives added nearly \$75 million in gross premiums written in 2010, after adding almost \$34 million to premiums in 2009. The increase in 2010 was due to growth in recent initiatives, as well as the expansion into crop reinsurance. Gross premiums written, as reflected in the following table, increased 1 percent in 2010, following a 7 percent decline in 2009 and 8 percent decline in 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 customers' 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 7 percent in 2010, following declines of 17 percent in 2009 and 13 percent in 2008. On the property side, premium increased 13 percent in 2010 and 3 percent in 2009, after declining in 2008. The result for 2010 was driven by the addition of crop reinsurance, while the property result for 2009 was driven by increased premium in facultative reinsurance, a new coverage launched in 2007. Our surety segment posted increased premium in 2010, 2009 and 2008, due largely to underwriter additions and geographic expansion.

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 benefited from light hurricane seasons in both 2010 and 2009. In addition, after experiencing a significant amount of unfavorable loss experience in 2009 and 2008 on marine coverages, this segment's results for 2010 benefited from favorable loss emergence. 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,		
	2010	2009	2008
Casualty	\$309,202	\$333,059	\$403,337
Property	235,058	207,444	200,794
Surety	92,056	90,697	77,038
Total	\$636,316	\$631,200	\$681,169

UNDERWRITING INCOME (in thousands)	Year ended December 31,		
	2010	2009	2008
Casualty	\$38,239	\$51,488	\$46,507
Property	34,085	23,261	15,813
Surety	23,071	12,036	20,743
Total	\$95,395	\$86,785	\$83,063

COMBINED RATIO	Year ended December 31,		
	2010	2009	2008
Casualty	83.4	80.6	85.2
Property	81.2	85.0	89.3
Surety	71.3	83.2	69.7
Total	80.7	82.3	84.2

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

(in thousands)	Year ended December 31,		
	2010	2009	2008
CASUALTY			
General liability	\$ 96,659	\$115,439	\$140,891
Commercial and personal umbrella	61,370	62,388	65,091
Commercial transportation	40,262	42,185	46,710
Executive products	15,841	15,553	13,846
Specialty program business	7,188	21,577	38,340
Other	9,799	7,879	8,603
Total	\$231,119	\$265,021	\$313,481
PROPERTY			
Commercial property	\$ 80,471	\$ 81,828	\$ 85,271
Marine	47,981	52,470	48,166
Crop reinsurance	27,082	—	—
Property reinsurance	9,960	7,843	1,649
Other property	16,151	13,162	11,777
Total	\$181,645	\$155,303	\$146,863
SURETY			
Total	\$ 80,618	\$ 71,637	\$ 68,420
Grand total	\$493,382	\$491,961	\$528,764

Casualty

Casualty gross premiums written of \$309.2 million were down 7 percent in 2010, following declines of 17 percent in 2009 and 13 percent in 2008. 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 \$98.5 million, down 15 percent from 2009. This result followed declines of 17 percent in 2009 and 21 percent in 2008. Rates were down 3 percent in 2010, following declines of 5 percent in 2009 and 12 percent in 2008. In addition, a large portion 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. Also during 2010, the habitational (owner, landlord and tenant/non-construction) component of the general liability book sustained adverse loss experience. Re-underwriting efforts were initiated that resulted in the nonrenewal of certain policies, as well as rate increases on policies where pricing was inadequate to cover losses. The combination of these efforts resulted in lost business, which negatively impacted premiums written. Commercial umbrella and transportation also sustained reductions in gross premiums written in each of the last three years, including declines in 2010 of 11 percent and 9 percent,

respectively. These results were reflective of 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. 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 35 percent in 2010 after declining 75 percent in 2009. Adverse loss experience on specialty programs resulted in our re-underwriting of this business, including exiting certain unprofitable programs and scaling back others. In addition, our deductible buy-back coverage was discontinued in 2008. On a positive note, our professional liability coverage for design professionals that was launched in 2009 posted \$14.4 million in gross premiums written in 2010, nearly doubling the result for 2009, and in line with expectations. We will remain disciplined in our approach to underwriting coverages in the casualty segment and the soft marketplace is likely to continue to challenge our ability to grow premium in this segment in 2011.

Underwriting income for the casualty segment was \$38.2 million in 2010, compared to \$51.5 million in 2009 and \$46.5 million in 2008. These results translated into combined ratios of 83.4, 80.6, and 85.2, respectively. Favorable development on prior accident years' loss reserves totaled \$65.3 million, \$65.5 million and \$50.6 million, for 2010, 2009 and 2008, respectively. While the result for 2010 included favorable development on the 1987 accident year from the settlement of an assumed run-off casualty claim, the majority of the favorable emergence over the last three years 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 many casualty coverages for mature accident years was lower than carried reserves, resulting in the release of reserves.

The segment's loss ratio was 49.1 in 2010, compared to 46.3 in 2009 and 54.2 in 2008. Each year benefited from favorable reserve development on prior accident years. Current accident year loss ratios, however, have continued to increase. 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 2010 and 2009, compared to 31.0 in 2008. While operating performance has resulted in increased bonus and profit sharing expenses in the last two years, the continued decline in net premiums earned has resulted in reduced leverage on acquisition and other insurance operating expenses, and as such, a higher expense ratio.

Property

Gross premiums written in the property segment increased by 13 percent in 2010 after posting a 3 percent increase in 2009. These increases follow a decline in premium of 3 percent in 2008. The result for both 2010 and 2009 was due to recent product launches. In January 2010, we initiated a crop reinsurance program in which we began assuming multi-peril crop insurance (MPCI) and crop hail exposure under a quota share agreement. The new crop reinsurance agreement added \$27.1 million in gross premiums written in 2010. In addition, our facultative reinsurance division, launched in 2007, produced \$15.2 million in premium in 2010, as it continued to build out its footprint. This result was a 31 percent increase in premiums in 2010 after more than doubling in 2009. Lastly, other treaty reinsurance agreements, which were launched in the later part of 2009, expanded in 2010 to include industry loss warranty (ILW) treaties. Under the ILW treaties, we provide reinsurance coverage for windstorm losses if two loss triggers (an industry loss limit trigger and a retention trigger) are met. Our diversification effort into the other assumed reinsurance arrangements added gross premiums written of \$4.0 million in 2010. Offsetting these increases, gross premiums written for commercial property declined 3 percent in 2010. We continued to manage our catastrophe exposures as rates softened, due to a second consecutive benign catastrophe season. In addition to the decline in commercial property, gross premiums written for marine coverages also declined. Marine premiums were down 7 percent in 2010, following a decline of 5 percent in 2009. Marine sustained adverse loss experience in 2009, particularly in hull (liability) and protection and indemnity coverages. 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.

Underwriting income was \$34.1 million in 2010, compared to income of \$23.3 million in 2009 and \$15.8 million in 2008. The segment's results translated into combined ratios of 81.2, 85.0, and 89.3, for 2010, 2009 and 2008, respectively. Results for 2010 and 2009 benefited from a benign catastrophe season and reserves for the 2008 hurricanes have continued to trend favorably, resulting in reserve take-downs. In 2008, underwriting income was impacted by \$22.8 million in losses associated with Hurricanes Gustav and Ike. Additionally, results for 2010 benefited from underwriting income on the crop reinsurance program, as well as favorable development on prior accident years' losses for marine. In contrast, results for 2009 included unfavorable loss experience on current and prior accident years for marine. This development was primarily attributable to the commercial tug and towing class that impacted 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. 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. While we are encouraged by the improvement in marine results in 2010, we continue to closely monitor the results for these coverages.

Surety

Gross premiums written for surety have increased in each of the last three years, as have net premiums earned, improving by 13 percent in 2010, 5 percent in 2009 and 9 percent in 2008. Investment in capacity, through underwriter additions and geographic expansion, fueled premium growth in contract and miscellaneous surety in all three years and in commercial surety in 2010. 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 premiums for fidelity coverages grew in 2009, they retreated in 2010 as we re-evaluated expanded policy terms and conditions currently available in the marketplace for this product.

Underwriting income totaled \$23.1 million in 2010, compared to \$12.0 million in 2009 and \$20.7 million in 2008. The segment's results translated into combined ratios of 71.3, 83.2, and 69.7 for 2010, 2009 and 2008, respectively. These represent excellent results for this segment. The segment's loss ratio was 6.6 in 2010, compared to 16.9 in 2009 and 4.8 in 2008. While all three years benefited from favorable development on prior accident years' reserves, our loss ratio was higher in 2009 as we established additional reserves due to our concerns over the economy and the normal delayed impact on contract and commercial surety accounts. During 2010, however, loss activity on these lines continued to be below expectations. Given the short-tail nature of surety losses, we released the additional reserves that had been established. Partially offsetting this release, we added \$1.1 million in reserves to the 2009 accident year for fidelity, due to losses associated with the financial crisis and expanded coverage conditions in this product line. The expense ratio for the surety segment was 64.7 in 2010, compared to 66.3 in 2009 and 64.9 in 2008. The increase in 2009 is reflective of increased acquisition costs associated with growth initiatives. As the relating premium from these investments began to earn as revenue in 2010, the expense ratio declined.

NET INVESTMENT INCOME AND REALIZED INVESTMENT GAINS

During 2010, net investment income decreased by 1 percent primarily due to a falling interest rate environment driving lower reinvestment rates. The average annual yields on our investments were as follows for 2010, 2009 and 2008:

	2010	2009	2008
PRETAX YIELD			
Taxable (on book value)	4.71%	5.03%	5.58%
Tax-exempt (on book value)	3.77%	3.79%	3.99%
Equities (on fair value)	2.69%	2.72%	3.81%
AFTER-TAX YIELD			
Taxable (on book value)	3.06%	3.27%	3.63%
Tax-exempt (on book value)	3.57%	3.59%	3.78%
Equities (on fair value)	2.31%	2.33%	3.27%

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 35.0 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 2010, the average after-tax yield on the fixed income portfolio declined to 3.1 percent from the 3.4 percent yield in 2009. During the year, we focused on purchasing high-quality fixed income investments, primarily defensive in nature in the 5 to 15 year range of the yield curve.

The fixed income portfolio decreased by \$44.0 million during the year to raise funds to pay the special dividend declared and paid during the fourth quarter. This portfolio had net realized gains of \$15.7 million and a tax-adjusted total return on a mark-to-market basis of 5.6 percent. During 2010, our equity portfolio increased by \$59.2 million to \$321.9 million, due to increasing our allocation and strong market performance. As of December 31, 2010, our equity portfolio had net unrealized gains of \$108.8 million. The total return for the year on the equity portfolio was 13.9 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
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%
2010	1,827,761	66,799	23,243	28,695	6.5%	6.8%
5-yr Avg.	\$1,785,951	\$72,671	\$4,752	\$4,023	4.5%	5.2%

⁽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 \$23.2 million in net investment gains in 2010 relating mostly to sales in the fixed income portfolio. Included in this number is \$7.4 million in net realized gains in the equity portfolio, \$15.7 million in net realized gains in the fixed income portfolio, and other realized gains of \$0.1 million. In 2009, we realized \$12.8 million in net investment losses. We realized \$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 net investment losses of \$46.7 million. Included in this number are net realized losses of \$38.7 million in the equity portfolio, net realized losses of \$8.2 million in the fixed income portfolio, and other realized gains of \$0.2 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 2010, we did not recognize any OTTI losses. In 2009, we recognized OTTI losses of \$45.3 million. 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. There were \$76.2 million in losses associated with the OTTI of securities in 2008.

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, 2010. 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.

December 31, 2010 (in thousands)	<12 Mos.	12 Mos. & Greater	Total
U.S. Government			
Fair value	\$ 5,689	\$ —	\$ 5,689
Cost or amortized cost	5,880	—	5,880
Unrealized loss	(191)	—	(191)
U.S. Agency			
Fair value	\$295,897	\$ —	\$295,897
Cost or amortized cost	304,374	—	304,374
Unrealized loss	(8,477)	—	(8,477)
Mortgage Backed			
Fair value	\$ 43,852	\$ —	\$ 43,852
Cost or amortized cost	44,659	—	44,659
Unrealized loss	(807)	—	(807)
ABS/CMO*			
Fair value	\$ 2,160	\$ —	\$ 2,160
Cost or amortized cost	2,196	—	2,196
Unrealized loss	(36)	—	(36)
Corporate			
Fair value	\$110,772	\$1,951	\$112,723
Cost or amortized cost	113,813	2,012	115,825
Unrealized loss	(3,041)	(61)	(3,102)
States, political subdivisions and revenues			
Fair value	\$ 80,465	\$ 996	\$ 81,461
Cost or amortized cost	82,652	1,050	83,702
Unrealized loss	(2,187)	(54)	(2,241)
Subtotal, debt securities			
Fair value	\$538,835	\$2,947	\$541,782
Cost or amortized cost	553,574	3,062	556,636
Unrealized loss	(14,739)	(115)	(14,854)
Common stock			
Fair value	\$ 6,078	\$ —	\$ 6,078
Cost or amortized cost	6,372	—	6,372
Unrealized loss	(294)	—	(294)
Total			
Fair value	\$544,913	\$2,947	\$547,860
Cost or amortized cost	559,946	3,062	563,008
Unrealized loss	(15,033)	(115)	(15,148)

*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, 2010, including fair value, cost basis and unrealized gains and losses.

(in thousands)	Cost Basis	Fair Value	Net Unrealized		Net	Unrealized Gain/Loss ⁽¹⁾
			Gains	Losses		
Common stock:						
Consumer discretionary	\$ 15,414	\$ 21,158	\$ 5,744	\$ —	\$ 5,744	37.3%
Consumer staples	12,576	27,458	14,882	—	14,882	118.3%
Energy	10,635	23,796	13,161	—	13,161	123.8%
Financials	20,816	28,132	7,316	—	7,316	35.1%
Healthcare	5,322	13,528	8,206	—	8,206	154.2%
Industrials	18,040	33,921	15,881	—	15,881	88.0%
Information technology	18,072	28,149	10,077	—	10,077	55.8%
Materials	5,230	7,014	1,784	—	1,784	34.1%
Telecommunications	4,672	9,879	5,207	—	5,207	111.5%
Utilities	37,592	52,858	15,547	(281)	15,266	40.6%
ETFs	64,700	76,004	11,317	(13)	11,304	17.5%
Total	\$213,069	\$321,897	\$109,122	\$(294)	\$108,828	51.1%

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

As of December 31, 2010, we held two securities in our equity portfolio that were in unrealized loss positions. The total unrealized loss on these securities was \$0.3 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 153 positions at an unrealized loss as of December 31, 2010. Of these 153 securities, two have been in an unrealized loss position for 12 consecutive months or longer and these collectively represent \$0.1 million in unrealized losses. The fixed income unrealized losses can be primarily attributed to rising interest rates during the final three months of 2010, and are not credit-specific issues. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. In 2009, we adopted GAAP guidance on the recognition and presentation of OTTI. Accordingly, any credit-related impairment related to fixed income securities we do not plan to sell and for which we are not more-likely-than-not to be required to sell is recognized in net earnings, with the non-credit related impairment recognized

in comprehensive earnings. Based on our analysis, our fixed income portfolio is of a high credit quality and we believe we will recover the amortized cost basis of our fixed income securities. 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. There were no OTTI losses recognized in other comprehensive earnings in the periods presented.

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
- Downgrades in credit quality by a major rating agency.

Based on our analysis, we've concluded that the securities in an unrealized loss position were not other-than-temporarily impaired.

We determined the fair values of certain financial instruments based on the fair value hierarchy. GAAP guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value.

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. We continually monitor economic conditions, our capital position and the insurance market to determine our equity allocation. Given the improvement in economic trends, we have allowed our equity allocation to increase following the credit crises in late 2008 and early 2009 when we reduced our target equity allocation to diminish the volatility of our portfolio. As of December 31, 2010, the portfolio had a fair value of \$1.8 billion, down from \$1.9 billion at the end of 2009. The decrease in the value of the investment portfolio was the result of returning \$146.7 million in capital to shareholders in December 2010, in the form of a special dividend.

As of December 31, 2010, our investment portfolio had the following asset allocation breakdown:

PORTFOLIO ALLOCATION

Asset Class	Cost or Amortized Cost	Fair Value	Unrealized Gain/(Loss)	% of Total Fair Value	Quality
Agencies	\$ 391,540	\$ 384,539	\$ (7,001)	21.4%	AAA
Corporates	464,651	487,908	23,257	27.2%	A
Mortgage-backed	243,377	254,156	10,779	14.1%	AAA
ABS/CMO*	47,494	49,915	2,421	2.8%	AAA
Treasuries	15,771	15,824	53	0.9%	AAA
Munis	240,307	243,121	2,814	13.5%	AA
Total fixed income	\$1,403,140	\$1,435,463	\$ 32,323	79.9%	AA
Equities	\$ 213,069	\$ 321,897	\$108,828	17.9%	
Short-term investments	\$ 39,787	\$ 39,787	—	2.2%	
Total portfolio	\$1,655,996	\$1,797,147	\$141,151	100.0%	

*Asset-backed and collateralized mortgage obligations

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 2010 and 2009 portfolios. As of December 31, 2010, the carrying value of our fixed income portfolio consisted of 54 percent AAA-rated securities, 16 percent AA-rated securities, 21 percent A-rated securities and 9 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, 2010, our fixed income portfolio's duration was 4.6 years and remained diversified. During 2010, the total return on our bond portfolio on a tax-equivalent, mark-to-market basis was 5.6 percent.

In addition, at December 31, 2010, our equity portfolio had a fair value of \$321.9 million, all of which is classified as available-for-sale and is also a source of liquidity. Our equity portfolio comprised 18 percent of our total 2010 portfolio, versus 14 percent at December 31, 2009. 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 four 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 2010, the total return on our equity portfolio on a mark-to-market basis was 13.9 percent, compared to the S&P return of 15.1 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, 2010, our fixed income portfolio had the following rating distributions:

FAIR VALUE

(in thousands)	AAA	AA	A	BBB	No Rating	Fair Value
Bonds:						
Corporate – financial	\$ –	\$ 25,276	\$ 93,744	\$ 10,923	\$ 6,055	\$ 135,998
All other corporate	–	14,684	160,245	97,161	–	272,090
Financials – private placements	–	14,563	20,243	7,448	–	42,254
All other corporates – private placements	9,875	3,304	18,034	6,353	–	37,566
U.S. govt. agency (GSE)	400,112	–	251	–	–	400,363
Tax-Exempt municipal securities	63,964	166,227	9,497	3,433	–	243,121
Structured:						
GSE – RMBS	\$ 254,156	\$ –	\$ –	\$ –	\$ –	\$ 254,156
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	9,704	–	–	–	–	9,704
CMBS	40,211	–	–	–	–	40,211
CDOs/CLOs	–	–	–	–	–	–
Total	\$ 778,022	\$ 224,054	\$ 302,014	\$ 125,318	\$ 6,055	\$ 1,435,463

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 \$6.1 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, 2010, MBS investments totaled \$254.2 million (18 percent) of the fixed income portfolio compared to \$241.6 million (16 percent) as of December 31, 2009.

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, 2010, \$29.3 million (11 percent) of the MBS portfolio was invested in planned amortization class CMOs (PACs) compared to \$28.3 million (12 percent) as of December 31, 2009. 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 85 percent of pure pass-throughs as of December 31, 2010, compared to 87 percent as of December 31, 2009. As of December 31, 2010, 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
2010				
Planned amortization class	AAA	\$ 27,038	\$ 29,299	11%
Sequential	AAA	9,297	9,198	4%
Pass-throughs	AAA	207,042	215,659	85%
Total		\$243,377	\$254,156	100%
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%

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. Our entire ABS portfolio is comprised of rate reduction utility bonds. As of December 31, 2010, ABS/CMBS (commercial mortgage-backed securities) investments were \$49.9 million (3 percent) of the fixed income portfolio, compared to \$50.8 million (3 percent) as of December 31, 2009. CMBS made up \$40.2 million (81 percent) of the ABS/CMBS portfolio at December 31, 2010, compared to \$38.2 million (75 percent) at December 31, 2009. The entire ABS/CMBS portfolio was rated AAA as of December 31, 2010.

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
2010				
CMBS	AAA	\$38,513	\$40,211	81%
Home equity		—	—	—
Auto		—	—	—
Equipment		—	—	—
Franchise		—	—	—
Utility	AAA	8,981	9,704	19%
Credit card		—	—	—
Total		\$47,494	\$49,915	100%
2009				
CMBS	AAA	\$37,585	\$38,188	75%
Home equity		—	—	—
Auto		—	—	—
Equipment		—	—	—
Franchise		—	—	—
Utility	AAA	11,852	12,645	25%
Credit card		—	—	—
Total		\$49,437	\$50,833	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 carry the highest credit rating by one or more major rating agency and continue to pay according to contractual terms. Unrealized losses in this asset class were \$0.8 million as of December 31, 2010, compared to \$0.5 million at the end of last year.

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, 2010.

Municipal Fixed Income Securities

As of December 31, 2010, municipal bonds totaled \$243.1 million (17 percent) of our fixed income portfolio as compared to \$413.2 million (28 percent) as of December 31, 2009. We reduced our overall exposure to municipal bonds primarily due to our concerns over the financial conditions of states and local municipalities.

We believe municipal fixed income securities can provide diversification and additional tax-advantaged yield to our portfolio. Our objective for the municipal fixed income portfolio is to provide reasonable cash flow stability and increased after tax yield. If financial conditions for municipal securities improve and we are being adequately compensated for the risk, we will increase our asset allocation to this class.

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, 2010, approximately 63 percent of the municipal fixed income securities in the investment portfolio were GO and the remaining 37 percent were revenue fixed income. Ninety-five percent of our municipal fixed income securities were rated AA or better, while 99 percent were rated A or better.

The amortized cost and fair value of fixed income securities at December 31, 2010, by contractual maturity, are shown as follows:

TOTAL FIXED INCOME

(in thousands)	Amortized Cost	Fair Value
Due in one year or less	\$ 27,591	\$ 27,861
Due after one year through five years	140,934	148,134
Due after five years through 10 years	465,817	485,318
Due after 10 years	477,927	470,079
Mtge/ABS/CMO*	290,871	304,071
Total	\$1,403,140	\$1,435,463

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

Corporate Debt Securities

As of December 31, 2010, our corporate debt portfolio totaled \$487.9 million (34 percent) of the fixed income portfolio compared to \$438.4 million (30 percent) as of December 31, 2009. The corporate debt portfolio has an overall quality rating of single A, diversified amongst 164 issuers.

The following table illustrates our corporate debt exposure to the financial and non-financial sectors as of December 31, 2010, including fair value, cost basis and unrealized gains and losses:

Amortized (in thousands)	Cost	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
Bonds:				
Corporate – financial	\$130,801	\$135,998	\$ 5,753	\$ (556)
All other corporate	255,313	272,090	18,170	(1,393)
Financials – private placements	41,933	42,254	1,069	(748)
All other corporate – private placements	36,604	37,566	1,367	(405)
Total	\$464,651	\$487,908	\$26,359	\$(3,102)

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. We believe it is probable that the securities in our portfolio will continue to receive contractual payments in the form of principal and interest.

Government Sponsored Entity (GSE) Debt Securities

As of December 31, 2010, our GSE or Agency debt portfolio totaled \$384.5 million (27 percent) of the fixed income portfolio, compared to \$332.7 million (22 percent) as of December 31, 2009. GSE securities carry no explicit government guarantee of creditworthiness, but are considered high quality partly due to an “implicit guarantee” that the government would not allow such important institutions to fail or default on debt. This implicit guarantee was tested during the subprime mortgage crisis, which caused the U.S. government to intervene and provide support of Fannie Mae and Freddie Mac. The GSE debt portfolio has an overall quality rating of AAA. The majority of our GSE portfolio is made up of defensive structures to provide some protection against rising interest rates. The GSEs currently have explicit support of the Federal Government, which we continue to monitor.

EQUITY SECURITIES

As of December 31, 2010, our equity portfolio totaled \$321.9 million (18 percent) of the investment portfolio compared to \$262.7 million (14 percent) as of December 31, 2009. 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 four exchange traded funds. During 2010, we did not record any impairment losses associated with equity securities. In 2009, we recorded impairment losses of \$40.7 million on our equity securities.

The following table illustrates the distribution by sector of our equity portfolio as of December 31, 2010, including fair value, cost basis and unrealized gains and losses:

(in thousands)	Cost Basis	Fair Value	% of Total Fair Value	Net Unrealized Gain/Loss
Common stock:				
Consumer discretionary	\$ 15,414	\$ 21,158	6.6%	\$ 5,744
Consumer staples	12,576	27,458	8.5%	14,882
Energy	10,635	23,796	7.4%	13,161
Financials	20,816	28,132	8.7%	7,316
Healthcare	5,322	13,528	4.2%	8,206
Industrials	18,040	33,921	10.5%	15,881
Information technology	18,072	28,149	8.8%	10,077
Materials	5,230	7,014	2.2%	1,784
Telecommunications	4,672	9,879	3.1%	5,207
Utilities	37,592	52,858	16.4%	15,266
ETFs	64,700	76,004	23.6%	11,304
Total	\$213,069	\$321,897	100.0%	\$108,828

Common Stocks

As of December 31, 2010, our common stock portfolio totaled \$245.9 million (76 percent) of the equity portfolio compared to \$228.4 million (87 percent) as of December 31, 2009. The increase in value of our common stock portfolio in 2010 was primarily due to the strong returns in the asset class.

Our common stock portfolio consists largely of large cap, value oriented, dividend paying securities. We employ a long-term, buy-and-hold strategy that has provided superior returns over the last 10 years. 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 similar to a regular stock.

Three of our ETF holdings are stock portfolios that track to major indices. The fourth is a bond portfolio that tracks a high-yield corporate index. We believe this ETF strategy is a low cost, efficient vehicle enabling us to effectively participate in certain sectors of the market.

In 2010, we added the high-yield corporate bond exchange traded fund to our ETF portfolio. As of December 31, 2010, our ETF investment totaled \$76.0 million (24 percent) of the equity portfolio compared to \$34.3 million (13 percent) as of December 31, 2009. The ETF investments add diversification, liquidity and increased return potential to our portfolio.

INTEREST AND GENERAL CORPORATE EXPENSE

Interest on debt was flat in 2010, after declining in 2009 and 2008. The decline in 2009 and 2008 was due to the pay off of short-term debt during 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. 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 2010, 2009 and 2008, 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 2010 and 2009, 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 were flat in

2010 after declining in both 2009 and 2008, 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 2010, we recorded \$7.1 million in earnings from this investment compared to \$5.1 million in 2009 and \$4.8 million in 2008. In 2010, sunglass sales were up 26 percent due to domestic and international product expansion. This result follows a 14 percent decline in sales in 2009, which was impacted by 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. In 2008, sunglass sales had advanced 7 percent but 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 a modest loss of \$2.0 million in 2010. Profits generated from the increased sales volume in 2010 served to more than offset the foreign exchange loss incurred.

In 2010 and 2008, we received dividends from Maui Jim. While these dividends do not flow through the investee earnings line, they do result in the recognition of a tax benefit, which is discussed in the income tax section that follows.

INCOME TAXES

Our effective tax rates were 28.6 percent, 29.1 percent and 26.2 percent for 2010, 2009 and 2008, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2010 was slightly lower than 2009, even though we recorded net realized gains (instead of incurring net realized losses), and increased underwriting income during the year. While underwriting income and net realized gains advanced in 2010, the effective rate declined due to tax benefits on dividends paid during the year, as well as benefits associated with an affiliated dividend received.

Dividends paid to our Employee Stock Ownership Plan (ESOP) result in a tax deduction. As a result, the \$7.00 per share special dividend (\$10.3 million) paid to the company's ESOP resulted in a \$3.6 million tax benefit. This tax benefit reduced the effective rate by 2 percent.

Our net earnings include equity in earnings of unconsolidated investee, Maui Jim. This investee does not have a policy or pattern of paying dividends. As a result, we record a deferred tax liability on the earnings at the corporate capital gains rate of 35 percent. In the fourth quarter 2010, we

received a \$7.9 million non-recurring dividend. In accordance with GAAP guidelines on income taxes, we recognized a \$2.2 million tax benefit from applying the lower tax rate applicable to affiliated dividends (7 percent), as compared to the corporate capital gains rate on which the deferred tax liabilities were based. Standing alone, the dividend resulted in a 1 percent reduction to the effective tax rate. The last time we received a non-recurring dividend from Maui Jim was the third quarter of 2008 (\$4.0 million with a tax benefit of \$1.1 million).

In addition, our pretax earnings in 2010 included \$18.6 million of investment income that is partially exempt from federal income tax, compared to \$24.3 million and \$30.3 million in 2009 and 2008, respectively. During 2010, we reduced our exposure to tax-exempt municipal bonds given concerns over the financial health of states and local municipalities.

Effective for tax years beginning in 2011, Illinois raised the state income tax rate applicable to corporations. Since the majority of our income arises from insurance operations which are subject to premium taxes, we expect the higher rate to have a minimal impact on our state income tax liability and our overall effective rate.

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 \$819.8 million at December 31, 2010, from \$810.1 million as of December 31, 2009. This reflects incurred losses of \$201.3 million in 2010 offset by paid losses of \$191.6 million, compared to incurred losses of \$203.4 million offset by \$202.3 million paid in 2009. The overall small increase in our net loss and LAE reserves between 2010 and 2009 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 casualty premiums earned in 2010 and favorable loss development of \$83.2 million from prior years.

Gross reserves (liability) and the reinsurance balances recoverable (asset) both increased slightly from a year ago

due to the same influences that affected net reserves. Total gross and ceded loss and LAE reserves increased to \$1.2 billion and \$354.2 million, respectively, at December 31, 2010, from \$1.1 billion and \$336.4 million, respectively, at December 31, 2009.

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 can also affect our income statement due to its impact on interest expense. As of December 31, 2010 and 2009, we had no short-term debt obligations. We maintain a debt obligation that is long-term in nature which 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 additional interest rate 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. 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, 2010. Listed on each table is the December 31, 2010, 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, 2010, our fixed income portfolio had a fair value of \$1.4 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2010, levels with all other variables held constant. Such scenarios would result in decreases in the fair value of the fixed income portfolio of \$63.3 million and \$135.8 million, respectively. Due to our use of the held-to-maturity designation for a portion of the fixed income portfolio, the balance sheet impact of these scenarios would be lower.

As of December 31, 2010, our equity portfolio had a fair value of \$321.9 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 \$28.2 million and \$56.3 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)	12/31/10 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 15	\$ –	\$ –
Total trading	15	–	–
Held for nontrading purposes			
Fixed income securities	1,435,448	(63,328)	–
Equity securities	321,897	–	(28,163)
Total nontrading	1,757,345	(63,328)	(28,163)
Total trading & nontrading	\$1,757,360	\$(63,328)	\$(28,163)

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

(in thousands)	12/31/10 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 15	\$ –	\$ –
Total trading	15	–	–
Held for nontrading purposes			
Fixed income securities	1,435,448	(135,775)	–
Equity securities	321,897	–	(56,326)
Total nontrading	1,757,345	(135,775)	(56,326)
Total trading & nontrading	\$1,757,360	\$(135,775)	\$(56,326)

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

(in thousands)	12/31/10 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 15	\$ –	\$ –
Total trading	15	–	–
Held for nontrading purposes			
Fixed income securities	1,435,448	47,210	–
Equity securities	321,897	–	28,163
Total nontrading	1,757,345	47,210	28,163
Total trading & nontrading	\$1,757,360	\$47,210	\$ 28,163

TABLE 4
Effect of a 200-basis-point decrease in interest rates and a 20% increase in the S&P 500:

(in thousands)	12/31/10 Fair Value	Interest Rate Risk	Equity Risk
Held for trading purposes			
Fixed income securities	\$ 15	\$ –	\$ –
Total trading	15	–	–
Held for nontrading purposes			
Fixed income securities	1,435,448	92,764	–
Equity securities	321,897	–	56,326
Total nontrading	1,757,345	92,764	56,326
Total trading & nontrading	\$1,757,360	\$92,764	\$ 56,326

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)	2010	2009	2008
Operating cash flows	\$100,235	\$127,759	\$161,334
Investing cash flows (uses)	92,606	(96,099)	(69,474)
Financing cash uses	(192,841)	(31,660)	(91,860)

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 \$150.6 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 decline from 2008 is largely due to a reduction in premium writings, our largest source of operating cash flow. During 2010, the majority of cash flows were used for financing activities. On December 1, 2010, our Board of Directors declared a special cash dividend of \$7.00 per share. A total of \$146.7 million was paid on December 29, 2010, to shareholders of record as of December 16, 2010.

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, 2010.

CONTRACTUAL OBLIGATIONS

(in thousands)	Payments due by period				Total
	Less than 1 yr.	1-3 yrs.	3-5 yrs.	More than 5 yrs.	
Loss and settlement expense	\$338,594	\$420,160	\$205,412	\$209,777	\$1,173,943
Long-term debt	—	—	100,000	—	100,000
Operating leases	3,417	5,399	3,724	1,944	14,484
Total	\$342,011	\$425,559	\$309,136	\$211,721	\$1,288,427

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. Reinsurance balances recoverable on unpaid loss and settlement reserves totaled \$354.2 million at December 31, 2010, compared to \$336.4 million in 2009. This increase is due to the soft market and increasing direct and ceded loss reserves in our casualty segment.

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. 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, 2010, we had short-term investments and other investments maturing within one year of approximately \$65.2 million and investments of \$217.9 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, 2010, 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, 2010, 2009 and 2008, our operating cash flow was \$100.2 million, \$127.8 million and \$161.3 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 (interest & dividends)	Commissions paid
Unconsolidated investee dividends from affiliates	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
Proceeds from stocks sold	Purchase of stocks
Proceeds from sale of unconsolidated investee	

We maintain a diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of December 31, 2010, our portfolio had a carrying value of \$1.8 billion. Invested assets at December 31, 2010, decreased by \$49.5 million, or 3 percent, from December 31, 2009 due in large part to the special dividend paid to shareholders.

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, 2010, 41 percent of our shareholders' equity was invested in equities, compared to 32 percent at December 31, 2009, and 41 percent at December 31, 2008.

We currently classify 21 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 (79 percent) or trading (less than 1 percent) and are carried at fair value. As of December 31, 2010, we maintained \$1.1 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, 2010, our capital structure consisted of \$100.0 million in 10-year maturity senior notes (long-term debt) and \$791.4 million of shareholders' equity. Debt outstanding comprised 11 percent of total capital as of December 31, 2010.

Our 139th consecutive dividend payment was declared in early 2011 and will be paid in March 2011, in the amount of \$0.29 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 2011 without prior approval is \$129.3 million, which represents RLI Insurance Company's net income for 2010. The 12-month rolling dividend limitation in 2010, based on the above criteria, was \$78.4 million (or 10 percent of RLI Ins. policyholder surplus as of December 31, 2009). In 2010, total cash dividends of \$208.0 million were paid by RLI Ins. Of that amount, \$150.0 million was paid by RLI Ins. as an extraordinary dividend after seeking and receiving approval from the Illinois regulatory authorities in November 2010. The extraordinary dividend was paid to RLI Corp. in December 2010 and was used to support the special dividend paid to shareholders on December 29, 2010. The balance of the 2010 dividends paid to RLI Corp. were to provide additional capital for the share repurchase plan, regular quarterly shareholder dividends, interest on senior notes and general corporate expenses.

In the second quarter of 2010, we completed our \$200 million share repurchase program initiated in 2007. On May 6, 2010, our Board of Directors implemented a new \$100 million share repurchase program. For the year, we repurchased 438,783 shares at an average cost of \$54.37 per share (\$23.9 million). We have \$94.1 million of remaining capacity from the additional \$100 million stock repurchase program approved in 2010. The repurchase program may be suspended or discontinued at any time without prior notice.

OUTLOOK FOR 2011

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. Industry financial results have started to deteriorate as a result of decreasing prices, expense pressures, and anemic investment income from falling yields. The financial crisis, which began in 2007, has continued to impact our business as the economic recovery has been sluggish. However, as a result of industry excess capital, temperate loss cost trends, continued favorable reserve development, and the lack of any major U.S. catastrophe events, we believe insurance prices will likely remain flat to slightly down in 2011.

As previously announced, we have entered into a definitive agreement to purchase CBIC and affiliated companies. We expect to close this transaction in early 2011. The company writes predominantly surety and casualty products for contractors in the western United States. We expect positive underwriting contributions from this business in 2011.

We have continued to invest in new products and underwriting talent throughout the soft market. We expect to see premium growth in selected organic products in 2011 and underwriting income overall, absent any major catastrophe. The company continues to diversify its portfolio of products, growing segments that still provide an opportunity for underwriting profit and shrinking those segments and products that are inadequately priced. Specific details regarding our insurance segments follow.

CASUALTY

We will maintain our underwriting focus and look to broaden our production sources and product offerings as a means of holding our market position in this segment. We do not expect significant growth in this segment from our mature products during 2011, but we have made several investments in new products in recent years that are still on a growth trajectory. These new products include professional liability for architects and engineers, environmental liability, real estate investment trusts liability, railroad protective liability, cyber liability, and multi-peril package products. We have also expanded our product offerings and eligibility guidelines for our personal umbrella and management liability suite of products which will expand our market penetration in 2011. The acquisition of CBIC should add additional growth to this segment for 2011.

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 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 continue to differentiate ourselves from the marketplace in 2011.

PROPERTY

We believe property pricing will be flat to competitive in the year ahead. Earthquake and hurricane-exposed business will be under significant rate pressure due to the lack of U.S. event activity in 2010 and 2009. Potentially offsetting these competitive pressures, catastrophe modeling firms will be introducing updates to their exposure models which may have a positive impact on market pricing. Our marine business will continue to 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 and 2010. That business unit is expected to enter into selected specialty treaty opportunities in 2011. We entered into two quota-share and an excess of loss assumed treaty reinsurance transactions during 2010 and continue to pursue others on an opportunistic basis. We anticipate 2011 growth in our multi-peril crop and hail reinsurance treaty from increasing commodity prices and underlying unit count increases. We

expect overall top line growth and underwriting income in this segment for 2011, absent any major catastrophes.

SURETY

The surety segment, like our other segments, is expected to feel the pressure of the stressed economic environment. In 2008 through 2010, we expanded our geographic footprint in miscellaneous, commercial, and contract surety and added a fidelity team. We expect organic premium growth for this segment to continue in 2011. Our experienced underwriting staff coupled with our effective use of technology point to continued profitability in 2011. The acquisition of CBIC should add additional growth to this segment for 2011.

INVESTMENTS

We remain cautiously optimistic regarding the U.S. economic recovery. The earnings outlook for corporations is generally favorable, the labor market is slowly improving, and the housing sector appears to have stabilized. We believe the market will be volatile in 2011 as investor expectation is confronted with occasional conflicting economic data.

We believe interest rates in the U.S. will increase as investors need to be compensated for additional risks associated with high debt levels and the potential inflation risk due to the accommodative monetary policies by the Fed. We also believe that the current economic data, coupled with strong corporate balance sheets and a positive earnings outlook, is favorable for continued positive equity returns in 2011.

In our fixed income portfolios, we will continue to see defensive strategies against rising yields and will continue to do so until the Fed changes their current course of accommodative monetary policies. On the equity side, we remain committed to our diversified, high quality strategy to provide long-term book value growth with lower volatility and superior dividend yield than the broader market.

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 consolidated 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.

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was passed in 2010 as a response to the economic recession in the late 2000s and represents significant change and increase in regulation of the American financial services industry. Dodd-Frank changes the existing regulatory structures of banking and other financial institutions, including creating a host of new agencies (while merging and removing others), increasing oversight of financial institutions and specialized oversight of institutions regarded as presenting a systemic risk, protecting consumers and investors, promoting transparency and accountability at financial institutions, enhancing regulation of capital markets, and a variety of additional changes affecting the overall regulation and operation of financial services businesses in America. The legislation also mandates new rules affecting executive compensation and corporate governance for public companies. In addition, Dodd-Frank contains insurance industry-specific provisions, including establishment of the Federal Office of Insurance (FOI) and streamlining the regulation and taxation of surplus lines insurance and reinsurance among the states. The FOI, part of the U.S. Dept. of Treasury, will have limited authority and no direct regulatory authority over the business of insurance. FOI's principal mandates include monitoring the insurance industry, collection of insurance industry information and data, and representation of the U.S. with international insurance regulators. Many aspects of Dodd-Frank will be implemented over time by various federal agencies, including bank regulatory agencies and the Securities and Exchange Commission (SEC).

As a public company with insurance company subsidiaries, several aspects of Dodd-Frank apply to our company. Specifically, provisions affecting executive compensation, corporate governance for public companies and those addressing the insurance industry will affect us. Accordingly, we will monitor, implement and comply with all Dodd-Frank related changes to our regulatory environment.

TERRORISM INSURANCE

The federal Terrorism Risk Insurance Act of 2002 (TRIA) 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.

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 2010, several bills were introduced in Congress that would impact and regulate various aspects of the insurance industry. Several of those bills were consolidated into Dodd-Frank which became law in 2010. Dodd-Frank is summarized above, including the elements that affect the insurance industry and insurance companies such as ours. Implementation of the insurance-specific aspects of Dodd-Frank is expected to take a year or more, including passage of enabling regulations and legislation at the state level. We will continue to monitor, implement and comply with all insurance-specific aspects of Dodd-Frank. We expect the intended reduction of state regulation of surplus lines insurance to positively affect our company, although the benefits may not be realized immediately. However, we cannot predict whether any such legislation will have an impact on our company. We will continue to monitor all federal insurance legislation.

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.