RLI CORP
Form 10-Q
October 31, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2007

or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission File Number: 001-09463

RLI Corp.

(Exact name of registrant as specified in its charter)

ILLINOIS	**37-0889946**
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization)	Identification Number)
9025 North Lindbergh Drive, Peoria, IL	**61615**
(Address of principal executive offices)	(Zip Code)

(309) 692-1000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of October 19, 2007 the number of shares outstanding of the registrant s Common Stock was 23,291,284.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	**For the Three-Month Period Ended September 30, 2007**	**2006**
Net premiums earned	$ 134,111	$ 138,245
Net investment income	20,433	18,316
Net realized investment gains	3,822	2,822
	158,366	159,383
Losses and settlement expenses	16,977	70,018
Policy acquisition costs	38,685	36,320
Insurance operating expenses	12,082	10,573
Interest expense on debt	1,913	1,662
General corporate expenses	3,401	1,898
	73,058	120,471
Equity in earnings of unconsolidated investees	2,047	4,650
Earnings before income taxes	87,355	43,562
Income tax expense	25,816	13,184
Net earnings	$ 61,539	$ 30,378
Other comprehensive earnings net of tax	9,861	25,231
Comprehensive earnings	$ 71,400	$ 55,609
Earnings per share:		
Basic:		
Basic net earnings per share	$ 2.61	$ 1.24
Basic comprehensive earnings per share	$ 3.03	$ 2.26
Diluted:		
Diluted net earnings per share	$ 2.56	$ 1.21
Diluted comprehensive earnings per share	$ 2.97	$ 2.21
Weighted average number of common shares outstanding		
Basic	23,541	24,590
Diluted	24,029	25,131
Cash dividends declared per common share	$ 0.22	$ 0.19

The accompanying notes are an integral part of the unaudited interim financial statements.

RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	**For the Nine-Month Period Ended September 30, 2007**	**2006**
Net premiums earned	$ 409,576	$ 391,499
Net investment income	58,500	52,580
Net realized investment gains	23,414	8,753
	491,490	452,832
Losses and settlement expenses	131,609	211,661
Policy acquisition costs	115,276	106,126
Insurance operating expenses	31,626	29,510
Interest expense on debt	4,968	5,054
General corporate expenses	7,441	5,407
	290,920	357,758
Equity in earnings of unconsolidated investees	7,770	12,257
Earnings before income taxes	208,340	107,331
Income tax expense	64,431	28,375
Net earnings	$ 143,909	$ 78,956
Other comprehensive earnings (loss) net of tax	(4,491)	13,437
Comprehensive earnings	$ 139,418	$ 92,393
Earnings per share:		
Basic:		
Basic net earnings per share	$ 6.03	$ 3.14
Basic comprehensive earnings per share	$ 5.84	$ 3.68
Diluted:		
Diluted net earnings per share	$ 5.91	$ 3.06
Diluted comprehensive earnings per share	$ 5.72	$ 3.58
Weighted average number of common shares outstanding		
Basic	23,861	25,116
Diluted	24,367	25,783
Cash dividends declared per common share	$ 0.64	$ 0.55

The accompanying notes are an integral part of the unaudited interim financial statements.

RLI Corp. and Subsidiaries Condensed Consolidated Balance Sheets

(in thousands, except share data)	September 30 2007 (unaudited)	December 31, 2006
ASSETS		
Investments		
Fixed maturities		
Available-for-sale, at fair value	$ 1,332,646	$ 1,234,571
Held-to-maturity, at amortized cost	79,091	106,310
Trading, at fair value	15,041	14,960
Equity securities, at fair value	370,379	368,195
Preferred stock, at fair value	39,260	
Short-term investments, at cost	84,815	104,205
Total investments	1,921,232	1,828,241
Accrued investment income	18,626	18,628
Premiums and reinsurance balances receivable	103,248	126,021
Ceded unearned premium	75,556	97,596
Reinsurance balances recoverable on unpaid losses	520,716	525,671
Deferred policy acquisition costs	82,010	73,817
Property and equipment	18,838	20,590
Investment in unconsolidated investees	38,538	36,667
Goodwill and indefinite-lived intangibles	26,214	26,214
Other assets	7,270	17,851
TOTAL ASSETS	$ 2,812,248	$ 2,771,296
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and settlement expenses	$ 1,291,133	$ 1,318,777
Unearned premiums	373,400	387,811
Reinsurance balances payable	68,364	85,046
Notes payable, short-term debt	52,644	
Income taxes-current	9,154	8,318
Income taxes-deferred	28,806	27,069
Bonds payable, long-term debt	100,000	100,000
Other liabilities	68,571	87,755
TOTAL LIABILITIES	$ 1,992,072	$ 2,014,776
Shareholders Equity		
Common stock ($1 par value)		
(31,857,640 shares issued at 9/30/07)		
(31,689,740 shares issued at 12/31/06)	31,858	31,690
Paid-in capital	191,537	187,632
Accumulated other comprehensive earnings	100,652	105,145
Retained earnings	722,906	594,147
Deferred compensation	7,762	7,744
Less: Treasury shares at cost		
(8,537,356 shares at 9/30/07)	(234,539)	(169,838)
(7,416,762 shares at 12/31/06)		
TOTAL SHAREHOLDERS EQUITY	820,176	756,520
TOTAL LIABILITIES AND SHAREHOLDER S EQUITY	$ 2,812,248	$ 2,771,296

The accompanying notes are an integral part of the unaudited interim financial statements.

RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)		**For the Nine-Month Period Ended September 30,** 2007		2006
Net cash provided by operating activities	$	111,228	$	142,765
Cash Flows from Investing Activities				
Investments purchased		(324,898)		(467,896)
Investments sold		133,940		332,930
Investments called or matured		91,365		79,071
Net change in short term investments		2,218		1,921
Changes in notes receivable		9,500		1,500
Net property and equipment purchased		(510)		(2,529)
Net cash used in investing activities	$	(88,385)	$	(55,003)
Cash Flows from Financing Activities				
Cash dividends paid	$	(14,876)	$	(13,381)
Payment on short-term debt				(10,557)
Proceeds from issuance of short-term debt		52,644		35
Stock option plan share issuance		2,141		3,634
Excess tax benefit from exercise of stock options		1,931		1,549
Treasury shares purchased		(64,683)		(69,042)
Net cash used in financing activities	$	(22,843)	$	(87,762)
Net increase in cash				
Cash at the beginning of the year				
Cash at September 30	$		$	

The accompanying notes are an integral part of the unaudited interim financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - The unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 2006 Annual Report on Form 10-K. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position at September 30, 2007 and the results of its operations for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the operating results for a full year.

The preparation of the unaudited condensed consolidated financial statements requires management to make estimates and assumptions relating to the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the unaudited condensed consolidated financial statements, and the reported amounts of revenue and expenses during the period. These estimates are inherently subject to change and actual results could differ from these estimates.

Earnings Per Share: Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock or common stock equivalents were exercised or converted into common stock. When inclusion of common stock equivalents increases the earnings per share or reduces the loss per share, the effect on earnings is anti-dilutive. Under these circumstances, the diluted net earnings or net loss per share is computed excluding the common stock equivalents.

Pursuant to disclosure requirements contained in Statement of Financial Accounting Standards (SFAS) 128, Earnings Per Share, the following represents a reconciliation of the numerator and denominator of the basic and diluted EPS computations contained in the unaudited condensed consolidated financial statements.

(in thousands, except per share data)	For the Nine-Month Period Ended September 30, 2007 Income (Numerator)	Shares (Denominator)	Per Share Amount	For the Nine-Month Period Ended September 30, 2006 Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 143,909	23,861	$ 6.03	$ 78,956	25,116	$ 3.14
Effective of Dilutive Securities						
Stock Options	0	506		0	667	
Diluted EPS						
Income available to common shareholders	$ 143,909	24,367	$ 5.91	$ 78,956	25,783	$ 3.06

(in thousands, except per share data)	For the Three-Month Period Ended September 30, 2007 Income (Numerator)	Shares (Denominator)	Per Share Amount	For the Three-Month Period Ended September 30, 2006 Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 61,539	23,541	$ 2.61	$ 30,378	24,590	$ 1.24
Effective of Dilutive Securities						
Stock Options	0	488		0	541	
Diluted EPS						
Income available to common shareholders	$ 61,539	24,029	$ 2.56	$ 30,378	25,131	$ 1.21

Adopted Accounting Standards:

SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155)

On January 1, 2007, we adopted SFAS 155, Accounting for Certain Hybrid Financial Instruments. SFAS 155 amends FASB Statement No. 133 and FASB Statement No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Companies are required to adopt the provisions of SFAS 155, as applicable, beginning in fiscal year 2007. The adoption of SFAS 155 had no impact on our financial position or results of operations.

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48)

On January 1, 2007, we adopted the provisions of FIN 48, Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 requires an entity to recognize the benefit of tax positions only when it is more likely than not, based on the position s technical merits, that the position would be sustained upon examination by the respective taxing authorities. The tax benefit is measured as the largest benefit that is more than fifty-percent likely of being realized upon final settlement with the respective taxing authorities. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 did not have an impact on our financial position or results of operations as we have taken no significant tax positions which would require accrual or disclosure under the new guidance. Although the IRS is not currently examining any of our income tax returns, tax years 2005 and 2006 remain open and are subject to examination.

Pending Accounting Standards:

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

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value and establishes a framework for measuring fair value in GAAP. The pronouncement describes fair value as being based on a hypothetical transaction to sell an asset or transfer a liability at a specific measurement date, as considered from the perspective of a market participant who holds the asset or owes the liability. In addition, fair value should be viewed as a market-based measurement, not an entity-specific measurement. SFAS 157 becomes effective for fiscal years beginning after November 15, 2007. We are currently reviewing the guidance provided in this standard to determine the impact on our financial position and results of operations.

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

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

Pension Plan: During 2003 through 2006, our board and management took a series of steps to gradually freeze and terminate our defined benefit pension plan. The plan termination was finalized in 2006. All plan distributions were made in late 2006. During the nine months ended September 30, 2006, we incurred $1,580,000 in pension expense. No expenses were incurred in 2007.

Intangible assets: In accordance with SFAS 142, Goodwill and Other Intangible Assets, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill and indefinite-lived intangible assets, which relate to our surety segment, are listed separately on the balance sheet and totaled $26.2 million at September 30, 2007 and December 31, 2006. Annual impairment testing was performed during 2007, pursuant to the requirements of SFAS 142. Based upon this review, these assets are not impaired.

Intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite-lived intangible assets that continue to be amortized under SFAS 142 relate to our purchase of customer-related and marketing-related intangibles. These intangibles have useful lives ranging from five to 10 years. Amortization of intangible assets was $0.1 million for the first nine months of 2007 and $0.2 million for the same period of 2006. At September 30, 2007, these assets were fully amortized.

2. STOCK BASED COMPENSATION During 2005, our shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). The purpose of the omnibus plan is to promote our interests and those of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a high level of corporate performance and to encourage our continued success and growth. Awards under the omnibus plan may be in the form of restricted stock, stock options (both incentive and nonqualified), stock appreciation rights, performance units, as well as other stock based awards. Eligibility under the omnibus plan is limited to our employees or employees of any affiliate and to individuals or entities who are not employees but who provide services to us or an affiliate, including services provided in the capacity of consultant, advisor or director. The granting of awards is solely at the discretion of the Executive Resources Committee and the Nominating/Corporate Governance Committee of our Board of Directors. The total number of shares of common stock available for distribution under the omnibus plan may not exceed 1,500,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we have granted 656,100 stock options under this plan, including 216,300 thus far in 2007.

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

The following tables summarize option activity in 2007 and 2006:

	Number of Options Outstanding		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life		Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2007	1,632,019	$	31.29			
Options granted	216,300	$	56.10			
Options exercised	(247,124)	$	22.85		$	8,711
Options canceled/forfeited	(5,840)	$	50.98			
Outstanding options at September 30, 2007	1,595,355	$	35.89	6.00	$	33,232
Exercisable options at September 30, 2007	1,219,154	$	30.41	5.02	$	32,074

	Number of Options Outstanding		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life		Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2006	1,931,627	$	26.53			
Options granted	191,100	$	50.03			
Options exercised	(339,762)	$	19.69		$	11,316
Options canceled/forfeited	(41,900)	$	39.21			
Outstanding options at September 30, 2006	1,741,065	$	30.14	5.66	$	35,955
Exercisable options at September 30, 2006	1,552,065	$	27.72	5.18	$	35,811

The majority of our options are granted annually at the board meeting in May. Thus far in 2007, 216,300 shares were granted with an average exercise price of $56.10 and an average fair value of $15.12. We recognized $1.1 million of expense in the first nine months of 2007 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of $0.4 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was $3.7 million, which will be recognized over the remainder of the vesting period.

The fair value of options was estimated using a Black-Scholes based option pricing model with the following grant-date assumptions and weighted average fair values as of September 30:

		2007		2006
Weighted-average fair value of grants	$	15.12	$	13.92
Risk-free interest rates		4.60%		5.02%
Dividend yield		1.47%		1.51%
Expected volatility		21.72%		22.41%
Expected option life		6.34 years		6.31 years

The risk-free rate is determined based on U.S. treasury yields that most closely approximate the option s expected life. The dividend yield is calculated based on the average annualized dividends paid during the most recent five-year period. The expected volatility is an implied volatility. This volatility is calculated by computing the weighted average of the most recent 1-year volatility, the most recent 6.34-year (equal to the expected life) volatility and the median of the 6.34-year rolling volatilities of RLI stock. The expected option life is determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year s grant.

3. OPERATING SEGMENT INFORMATION - Selected information by operating segment is presented in the table below. Additionally, the table reconciles segment totals to total earnings and total revenues.

SEGMENT DATA (in thousands)

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SEGMENT DATA (in thousands)	For the Three-Month Periods Ended September 30, REVENUES		For the Nine-Month Periods Ended September 30, REVENUES	
	2007	2006	2007	2006
Casualty	$ 84,252	$ 86,657	$ 260,051	$ 259,738
Property	34,013	36,590	103,108	87,583
Surety	15,846	14,998	46,417	44,178
Segment totals before income taxes	$ 134,111	$ 138,245	$ 409,576	$ 391,499
Net investment income	20,433	18,316	58,500	52,580
Net realized gains	3,822	2,822	23,414	8,753
Total revenues	$ 158,366	$ 159,383	$ 491,490	$ 452,832

	NET EARNINGS		NET EARNINGS	
	2007	2006	2007	2006
Casualty	$ 47,555	$ 18,711	$ 91,440	$ 34,232
Property	8,158	194	20,898	3,498
Surety	10,654	2,429	18,727	6,472
Net Underwriting Income	$ 66,367	$ 21,334	$ 131,065	$ 44,202
Net investment income	20,433	18,316	58,500	52,580
Net realized gains	3,822	2,822	23,414	8,753
General corporate expense and interest on debt	(5,314)	(3,560)	(12,409)	(10,461)
Equity in earnings of unconsolidated investee	2,047	4,650	7,770	12,257
Total earnings before income taxes	$ 87,355	$ 43,562	$ 208,340	$ 107,331
Income tax expense	25,816	13,184	64,431	28,375
Total net earnings	$ 61,539	$ 30,378	$ 143,909	$ 78,956

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

(in thousands)	For the Three-Month Periods Ended September 30, 2007	2006	For the Nine-Month Periods Ended September 30, 2007	2006
Casualty				
General liability	$ 41,364	$ 46,186	$ 128,010	$ 135,533
Commercial and personal umbrella	16,566	16,364	49,894	48,129
Commercial transportation	11,615	11,414	36,741	35,889
Specialty program business	7,467	6,009	21,964	18,795
Executive coverages	2,817	3,088	8,969	9,271
Other	4,423	3,596	14,473	12,121
Total	$ 84,252	$ 86,657	$ 260,051	$ 259,738
Property				
Commercial property	$ 22,283	$ 26,680	$ 70,583	$ 66,042
Construction	228	2,412	2,138	3,456
Marine	8,758	4,832	22,364	10,934
Other property	2,744	2,666	8,023	7,151
Total	$ 34,013	$ 36,590	$ 103,108	$ 87,583
Surety	$ 15,846	$ 14,998	$ 46,417	$ 44,178
Grand Total	$ 134,111	$ 138,245	$ 409,576	$ 391,499

A detailed discussion of earnings and results by segment is contained in management s discussion and analysis of financial condition and results of operations.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: This discussion and analysis may contain 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 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Various risk factors that could affect future results are listed in our filings with the Securities and Exchange Commission, including the Annual Report on Form 10-K for the year ended December 31, 2006.

OVERVIEW

We underwrite selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group (the Group). We conduct operations principally through three insurance companies. RLI Insurance Company, our principal subsidiary, writes multiple lines insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company, a subsidiary of RLI Insurance Company, writes surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company, a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines of insurance on an admitted basis in 49 states and the District of Columbia. We are an Illinois corporation that was organized in 1965. We have no material foreign operations.

As a niche company, we offer specialty insurance coverages designed to meet specific insurance needs of targeted insured groups and underwrite particular types of coverage for certain markets that are underserved by the insurance industry, such as our commercial earthquake coverage and 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 insurance market, which unlike the standard admitted market is less regulated and more flexible in terms of policy forms and premium rates, provides an alternative market for customers with hard-to-place risks. When we underwrite within the surplus lines market, we are selective in the line of business and type of risks we choose to write. Using our non-admitted status in this market allows us to tailor terms and conditions to manage these exposures more effectively than our admitted counterparts. Often the development of these specialty insurance coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients. Once a proposal is submitted, underwriters determine whether it would be a viable product in keeping with our business objectives.

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 or loss generated from our individual segments.

The foundation of our overall business strategy is to underwrite for profit. This drives our ability to provide shareholder returns in three different ways: the underwriting profit 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 property and casualty insurance business is cyclical and influenced by many factors, including price competition, economic conditions, natural or man-made disasters (for example, earthquakes, hurricanes, and terrorism), interest rates, state regulations, court decisions and changes in the law. One of the unique and challenging features of the property and casualty insurance business is that coverages must be priced before costs have fully developed, because premiums are charged before claims are incurred. This requires that liabilities be estimated and recorded in recognition of future loss and settlement obligations. Due to the inherent uncertainty in estimating these liabilities, there can be no assurance that actual liabilities will not be more or less than recorded amounts; if actual liabilities differ from recorded amounts, there will be an adverse or favorable effect on net earnings. In evaluating the objective performance measures previously mentioned, it is important to consider the following individual characteristics of each major insurance segment.

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

Our property segment primarily underwrites commercial fire, earthquake, difference in conditions, marine, 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 in the state of California. 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 attempt to limit our net aggregate exposure to a catastrophic event by purchasing reinsurance and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

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

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

GAAP and non-GAAP Financial Performance Metrics

Throughout this quarterly 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 presentation of net earnings and certain statutory reporting information, we show certain non-GAAP financial measures that we believe are valuable in managing our business, evaluating our performance, and drawing comparisons to our peers. These measures include 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 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 3 to the financial statements, Operating Segment Information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, general corporate expenses, debt costs, and unconsolidated investee earnings.

Gross premiums written

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

Net premiums written

While net premiums earned is the related GAAP measure used in the statements of earnings, net premiums written is the component of net premiums earned that measures gross premiums written less the cost 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 future earnings potential subject to our expenses and loss costs.

Combined ratios

This ratio is a common insurance industry measure of profitability for any underwriting operation, and is calculated in two components. First, the expense ratio reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. The second component, the loss ratio, is losses and settlement 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 referred to in our disclosures regarding the process of establishing these various estimated amounts.

Critical Accounting Policies

In preparing the condensed 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 condensed consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates.

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

Unpaid Losses and Settlement Expenses

Overview

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

recoveries, reinsurance, salvage, and subrogation. The reserves are reviewed regularly by a team of actuaries we employ with periodic review by outside independent actuarial firms.

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 loss adjustment expense 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 events 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 will be different from that anticipated at the reporting date. Therefore, actual paid losses in the future may yield a materially different amount than currently reserved favorable and unfavorable.

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

We record two categories of loss and loss adjustment expense reserves case-specific reserves and incurred but not reported (IBNR) reserves.

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

We establish Incurred But Not Reported (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 loss adjustment expense 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.

Loss adjustment expense (LAE) represents the cost involved in adjusting and administering losses from policies we sold. 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 the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, vice president of claims, vice president of underwriting, 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 September 30, 2007, make a reasonable provision to meet our future obligations.

Initial IBNR Generation Process

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

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

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

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

The historical and prospective loss and ALAE estimates along with the applicable risk factors identified above are the bases 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 and prevailing risk factors. The Loss Reserve Committee makes all final decisions regarding changes in the initial loss and ALAE ratios.

Loss and LAE Reserve Estimating Process

A full analysis of our loss reserves takes place at least semi-annually. The purpose of these analyses is to provide validation of our carried loss reserves. Estimates of the expected value of the unpaid loss and loss adjustment expense 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 actuarial process of estimating ultimate payment for claims and claims expenses begins with the collection and analysis of current and historical claim data. Data on individual reported claims including paid amounts and individual claim adjuster estimates are grouped by common characteristics. There is judgment involved in this grouping. Considerations when grouping data include the volume of the data available, the credibility of the data available, the homogeneity of the risks in each cohort, and both settlement and payment pattern consistency. We use this data to determine historical claim reporting and payment patterns which are used in the analysis of ultimate claim liabilities. For portions of the business without sufficiently large numbers of policies or that have not accumulated sufficient historical statistics, our own data is supplemented with external or industry average data as available and when appropriate. For our executive products and marine business, we utilize external data extensively.

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

We use historical development patterns, estimations of the expected loss ratios, and standard actuarial methods to derive an estimate of the ultimate level of loss and loss adjustment expense 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 loss adjustment expense and case reserve through the evaluation date is subtracted to reveal the resulting level of IBNR.

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

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

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

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

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

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

Given the significant impact of the reserve estimates on our financial statements, we subject the reserving process to significant diagnostic testing and outside review. Multiple outside reserving specialists periodically review the reserve estimation process and the resulting estimates. We give consideration to these outside opinions and implement recommended improvements as deemed appropriate. We have incorporated data validity checks and balances into our front-end processes. Leading indicators such as actual versus expected emergence and other diagnostics are also incorporated into the reserving processes.

Determination of Our Best Estimate

Upon completion of our full loss and loss adjustment expense estimation analysis, the results are discussed with the Loss Reserve Committee (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. Review of the variance between the indicated reserves and the carried reserves determined from the initial

IBNR generation process takes place. After discussion of these analyses and all relevant risk factors, the LRC determines whether the reserve balances require adjustment.

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

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

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

Our best estimate of our loss and LAE reserves may change depending on a revision in the actuarial point estimate, the actuary s certainty in the estimates and processes, and our overall view of the underlying risks.

As discussed in our previous SEC filings, including our 2006 10-K Annual Report and 10-Q Quarterly Report for the second quarter of 2007, the Company periodically reviews its loss reserve estimates and underlying actuarial reserving methodologies in order to assess their accuracy and suitability, and to benchmark its reserving practices against industry best practices. As part of its review, the Company has performed in the current quarter a detailed, ground-up analysis of the actuarial estimation risks associated with each of its products and segments, including consultation with external consultants and assessment of industry information.

Based on this review, the Company has made certain refinements to its reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves through increased internal dialogue among the claim, underwriting, risk management and actuarial departments, greater transparency of the actuarial process and results, and improved reserving diagnostics. Overall, these enhancements and improved information provide better and faster feedback to management regarding loss development resulting in greater overall confidence in the actuarial estimates. Although we anticipated that the reserving methodology review would not have a significant impact on carried reserves, these enhancements together with our increasingly diversified and stable portfolio of product lines in the last several years have allowed for a reduced variance of carried reserves over the actuarial point estimate, thus prompting the reduction in overall carried reserves outlined below. The Company believes that these reserve methodology enhancements have improved the overall accuracy of its best estimate of loss and loss adjustment expense reserves.

Our analyses also revealed that the Company s quarterly actuarial reserve estimates over recent historical periods have shown a downward trend as a result of a moderating loss trend environment, improvements in policy terms and conditions and a favorable underlying exposure mix that occurred during the hard market period from 2001 through 2004. The impact was most evident in our casualty and surety segments. Based on these factors and analyses, including the current consideration of such underlying trends in the actuarial estimates, the result is an adjustment to reduce the Company s overall carried loss reserves by $51.3 million, which has been recorded in the current quarter.

The table below outlines the favorable and unfavorable reserve adjustments by major product line/segment:

General Liability	$	(20.6M)
Transportation	$	(15.1M)
Programs	$	(8.0M)
Executive Products	$	(5.6M)
Personal Umbrella	$	(5.4M)
Other Casualty/Runoff	$	10.4M
Total Casualty	$	(44.3M)
Surety	$	(7.9M)
Property	$	0.9M

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 may occur as the actual emergence of losses is revealed over time. The Company believes its enhanced loss reserving processes reflect industry best practices and its methodologies continue to result in an appropriate best estimate of necessary reserve levels.

Investment Valuation

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

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

We regularly evaluate our fixed maturity, equity securities and preferred stock portfolios to determine impairment losses for other-than-temporary declines in the fair value of the investments. Criteria considered during this process include, but are not limited to: the current fair value as compared to the cost (amortized, in certain cases) of the security, degree and duration of the security s fair value being below cost, credit quality, current economic conditions, the anticipated speed of cost recovery, and our decisions to hold or divest a security. Part of our evaluation of whether particular securities are other-than-temporarily impaired involves assessing whether we have both the intent and ability to continue to hold securities in an unrealized loss position. Impairment losses result in a reduction of the underlying investment s cost basis. Significant changes in these factors could result in a considerable charge for impairment losses.

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. Our policy is to periodically charge to earnings an estimate of unrecoverable amounts from reinsurers. Further discussion of the security of our recoverable reinsurance balances can be found in note 5 to the financial statements included in our 2006 Annual Report on Form 10-K.

Deferred Policy Acquisition Costs

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

NINE MONTHS ENDED SEPTEMBER 30, 2007, COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2006

Consolidated revenues, as displayed in the table that follows, totaled $491.5 million for the first nine months of 2007 compared to $452.8 million for the same period in 2006.

	For the Nine-Month Period Ended September 30, 2007	2006
Consolidated revenues (in thousands)		
Net premiums earned	$ 409,576	$ 391,499
Net investment income	58,500	52,580
Net realized investment gains	23,414	8,753
Total consolidated revenue	$ 491,490	$ 452,832

Consolidated revenue for the first nine months of 2007 increased $38.7 million, or 9%, from the same period in 2006. Net premiums earned for the Group increased 5% from 2006 levels, as the significant growth in property premium experienced in 2006 was earned as revenue. Net realized investment gains increased $14.7 million to $23.4 million for the first nine months of 2007. Investment gains in 2007 relate to the sale of certain equity securities deemed to have reached their full value. Funds received were used

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to further diversify the investment portfolio. Net investment income improved 11% to $58.5 million. This improvement was primarily due to an increased asset base.

Net after-tax earnings for the first nine months of 2007 totaled $143.9 million, $5.91 per diluted share, compared to $79.0 million, $3.06 per diluted share, for the same period in 2006. Both periods reflect favorable development on prior years loss and hurricane reserves. In 2007, positive development on prior accident years hurricane and casualty and surety loss reserves resulted in additional pretax earnings of $87.8 million. This result includes the $51.3 million reduction in overall carried reserves in the third quarter, as detailed in Determination of Our Best Estimate on pages 21 through 23 of this document. In 2006, positive development on prior accident years loss and hurricane reserves resulted in additional pretax earnings of $17.8 million. Offsetting this favorable development in 2006 was an $8.7 million loss on construction coverages. Bonus and profit sharing-related expenses related to these specific items totaled $7.4 million in 2007 and $0.9 million in 2006. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital). In addition, general corporate expense includes an additional $1.0 million charitable contribution in 2007.

During the first nine months of 2007, equity in earnings of unconsolidated investees totaled $7.8 million, all related to Maui Jim, Inc. The first nine months of 2006 reflected $12.3 million in investee earnings, which included $8.3 million related to Maui Jim, Inc. and $4.0 million from Taylor, Bean & Whitaker Mortgage Corp. (TBW). In 2006, investee earnings from Maui Jim, Inc. included a $0.8 million gain from the sale of discontinued operations. In the fourth quarter of 2006, we sold our equity interest in TBW.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled $139.4 million, $5.72 per diluted share, for the first nine months of 2007, compared to comprehensive earnings of $92.4 million, $3.58 per diluted share, for the same period in 2006. Unrealized losses, net of tax, for the first nine months of 2007 were $4.5 million, compared to unrealized gains of $13.4 million for the same period in 2006.

The unrealized losses in the fixed income portfolio decreased slightly in the first nine months of 2007. While the equity portfolio exhibited a positive return in the first nine months of 2007, gains totaling $23.4 million were realized in the period. This move from unrealized to realized gains reduced unrealized gains on the equity portfolio.

RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group declined to $571.7 million for the first nine months of 2007 from $615.9 million in the first nine months of 2006, primarily attributable to a decrease in casualty and property writings. Underwriting income for the Group advanced $86.9 million to pre-tax income of $131.1 million for the first nine months of 2007. Underwriting income for 2007 included $87.8 million in favorable development on prior accident years hurricane and casualty and surety loss reserves. On a comparative basis, underwriting income for 2006 of $44.2 million included

$17.8 million in favorable development on prior accident years loss and hurricane reserves, offset by an $8.7 million underwriting loss on construction coverages. The GAAP combined ratio totaled 68.0 in 2007, compared to 88.7 in 2006. The decline in combined ratio was primarily attributable to the $51.3 million reduction in overall carried reserves. The Group s loss ratio decreased to 32.1 for 2007, compared to 54.1 for 2006. The loss ratio in 2007 included a greater amount of favorable development on prior accident years reserves, as discussed above, and improved performance of our property segment.

	For the Nine-Month Period Ended September 30,			
		2007		2006
Gross premiums written (in thousands)				
Casualty	$	352,886	$	378,704
Property		163,959		185,197
Surety		54,880		51,956
Total	$	571,725	$	615,857
Underwriting income (in thousands)				
Casualty	$	91,440	$	34,232
Property		20,898		3,498
Surety		18,727		6,472
Total	$	131,065	$	44,202
Combined ratio				
Casualty		64.9		86.9
Property		79.8		96.0
Surety		59.7		85.3
Total		68.0		88.7

Casualty

Gross premiums written for the casualty segment totaled $352.9 million for the first nine months of 2007, a decrease of $25.8 million, or 7%, from the same period last year. This decrease is primarily attributable to increased competition and continuing rate softening in the casualty segment. Despite this softening, margins remain good and we continue to find profitable opportunities. Gross premiums written for specialty program business advanced to $25.8 million for the first nine months of 2007, an increase of $3.1 million, or 14%, over the same period in 2006. In addition, gross premiums written for personal umbrella was $44.9 million for the first nine months of 2007, up $2.1 million, or 5%, from the same period in 2006. General liability, our largest growth contributor over the past several years, posted gross writings of $137.8 million, a decrease of $12.2 million, or 8%, from the same period last year. While rates have continued to deteriorate, this coverage has sustained profitable results. Transportation totaled $47.0 million, a decrease of $9.1 million, or 16%, from the first nine months of 2006, due to continuing price and volume declines. As the casualty market continues to soften, we will remain focused on growing areas that provide the best return, while maintaining strict adherence to underwriting discipline.

In total, the casualty segment posted underwriting income of $91.4 million, compared to $34.2 million for the same period last year. Both periods included favorable development on prior years loss and hurricane reserves. Results for

2007 include favorable experience on prior accident years (predominantly 2004 through 2006) primarily for general liability, umbrella, transportation, executive products, and employers indemnity, and on hurricanes (2005). Due to this positive emergence and continued improvement in loss reporting patterns, during the first nine months of 2007, we released reserves. These reserve releases improved the segment s underwriting results by $77.5 million.

From a comparative standpoint, results for 2006 included $14.5 million of favorable experience on prior accident years (1996-2003), primarily from executive products and general liability, and on hurricanes (2005). Overall, the combined ratio for the casualty segment was 64.9 for 2007 compared to 86.9 in 2006. The segment s loss ratio was 33.9 in 2007 compared to 58.4 in 2006 as reserves developed more favorably in 2007.

The expense ratio for the casualty segment was 31.0 for the first nine months of 2007 compared to 28.5 for the first nine months of 2006. The increase is primarily attributed to an increase in policy acquisition costs, which include, among other things, performance-related expenses such as bonus and profit sharing-related expenses.

Property

Gross premiums written for the property segment totaled $164.0 million, a decrease of $21.2 million, or 11%, from the same period last year. Our domestic fire book posted $65.4 million in gross written premiums, a decline of $29.5 million, or 31%, from the first nine months of 2006, as increased competition for non-catastrophe exposed accounts, combined with the softening of rates for coastal wind-exposed risks, have impacted the overall market. Offsetting this decline, our marine division reported $33.4 million in gross written premium during the first nine months of 2007, an increase of $13.3 million, or 67%, from the same period last year.

Net premiums earned for the segment totaled $103.1 million, an increase of $15.5 million, or 18%, from the first nine months of 2006 while net premiums written totaled $110.7 million, a decrease of $7.2 million, or 6%, from the same period in 2006. The increase in net premiums earned is reflective of the earning during 2007 of the significant increase in property premium written during the first three quarters of 2006.

Underwriting income for the segment was $20.9 million for the first nine months of 2007, compared to $3.5 million for the same period in 2006. Both periods benefited from light hurricane seasons. In addition, results for 2007 include a decline in losses from tornadoes and hailstorms, as well as lowered frequency and severity of commercial fire and construction losses. Additionally, while the segment benefited in 2006 from a light hurricane season, other catastrophe losses, such as tornadoes and hailstorms, along with increased severity of commercial fire losses, negatively impacted results for 2006. In 2006, losses and reinstatement premiums associated with the run-off of previously exited construction coverages adversely impacted results by $8.7 million. Partially offsetting these losses in 2006 was $3.3 million of hurricane reserve releases.

Segment results for 2007 translate into a combined ratio of 79.8, compared to 96.0 for the same period last year. The segment s loss ratio declined to 44.0 from 57.2 in 2006, due to the aforementioned improvement in loss activity in 2007.

From an expense standpoint, the segment s expense ratio improved to 35.8 from 38.8 in 2006. The expense ratio for the first nine months of 2006 was slightly higher due to start-up expenses associated with the new marine division, coupled with additional costs to reinstate reinsurance coverage exhausted by the increase in developed losses.

Surety

The surety segment posted gross premiums written of $54.9 million for the first nine months of 2007, an increase of $2.9 million, or 6%, from the same period last year. Premium growth was experienced across miscellaneous, commercial and energy lines. The segment posted underwriting income of $18.7 million, compared to an income of $6.5 million for the same period last year.

Results for 2007 reflect improved loss reporting patterns for contract, commercial, energy and miscellaneous surety. Due to this positive experience we released reserves. These reserve releases, primarily from accident years 2004 through 2006, improved the segment s underwriting results by $9.5 million.

The combined ratio for the surety segment totaled 59.7 in 2007, versus 85.3 for the same period in 2006. The segment s loss ratio was (3.9) for 2007, compared to 22.5 for 2006, as favorable loss trends have resulted in a reduction in carried reserves. The expense ratio increased slightly to 63.6 compared to 62.8 for the same period last year.

We are in litigation regarding certain commercial surety bond claims arising out of a specific bond program (the Commercial Money Center or CMC litigation). On June 7, 2007, we reached a confidential settlement agreement with Sky Bank related to the CMC litigation , which litigation was previously disclosed in various SEC filings , including Item 3 - Legal Proceedings of our 2006 Annual Report on Form 10-K. Additionally, on August 14, 2007, we reached a confidential settlement agreement with Ameriana Bank. These settlements end our litigation with Sky Bank and Ameriana Bank but do not resolve our pending litigation with the remaining two investor banks. The settlements with Sky Bank and Ameriana Bank relate to surety bonds representing approximately 52% and 14%, respectively, of the amount to which the investor banks had claimed entitlement. The settlements did not have a material adverse impact on our financial statements taken as a whole. While it is impossible to ascertain the ultimate outcome of the pending litigation between RLI and the remaining two investor banks at this time, we continue to believe we have meritorious defenses with respect to each of the remaining banks making claims and we will continue to vigorously assert those defenses in the pending litigation. We believe that we are adequately reserved for the ultimate outcome of the remaining litigation and that the resolution will not have a material adverse effect on the Company s financial position or on our financial statements taken as a whole. However, litigation is subject to inherent uncertainties, and if there were an outcome unfavorable to us, there exists the possibility of a material adverse impact on our financial condition, results of operations or cash flows in the period in which the outcome occurs.

INVESTMENT INCOME AND REALIZED CAPITAL GAINS

During the first nine months of 2007, net investment income increased by 11.3% over that reported for the same period in 2006. This improvement was primarily due to an increased asset base. On an after-tax basis, investment income increased by 10.1%. The average annual yields on our investments for the first nine months of 2007 and 2006 were as follows:

	2007	2006
Pretax Yield		
Taxable	5.41%	5.21%
Tax-Exempt	4.01%	3.98%
After-tax yield		
Taxable	3.52%	3.39%
Tax-Exempt	3.80%	3.77%

The fixed-income portfolio increased by $70.9 million during the first nine months of 2007. This portfolio had a tax-adjusted total return on a mark-to-market basis of 4.1%. Our equity portfolio increased by $2.1 million during the first nine months of 2007, to $370.4 million. The equity portfolio had a total return of 8.5% during the first nine months of 2007. In 2007, we began investing in preferred stock securities. The preferred stock portfolio had a fair value of $39.3 million at September 30, 2007. The preferred portfolio had a total return of -5.0% during the first nine months of 2007.

We realized a total of $23.4 million in capital gains in the first nine months of 2007, compared to capital gains of $8.8 million in the first nine months of 2006. Investment gains in 2007 relate to the sale of certain equity securities deemed to have reached their full value. Funds received were used to further diversify the investment portfolio.

We regularly evaluate the quality of our investment portfolio. When we believe that a specific security has suffered an other-than-temporary decline in value, the investment s value is adjusted by reclassifying the decline from unrealized to realized losses. This has no impact on shareholders equity. During the first nine months of 2007 and 2006, there were no losses associated with the other-than-temporary impairment of securities.

The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity and preferred stock portfolio as of September 30, 2007, including fair value, cost basis, and unrealized gains and losses.

	9/30/2007					
	Cost Basis	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Net	Unrealized Gain/Loss % (1)
	(dollars in thousands)					
Consumer Discretionary	$ 15,619	$ 19,849	$ 4,508	$ (278)	$ 4,230	27.1%
Consumer Staples	16,215	33,975	17,842	(82)	17,760	109.5%
Energy	8,447	33,850	25,403		25,403	300.7%
Financials	27,962	56,149	28,509	(322)	28,187	100.8%
Healthcare	13,817	29,480	15,936	(273)	15,663	113.4%
Industrials	16,275	40,481	24,727	(521)	24,206	148.7%
Materials	7,178	8,725	1,547		1,547	21.6%
Information Technology	14,103	26,405	12,302		12,302	87.2%
Telecommunications	5,159	14,995	9,836		9,836	190.7%
Utilities	44,305	68,019	23,735	(21)	23,714	53.5%
Preferred Stocks	41,744	39,260	70	(2,554)	(2,484)	-6.0%
Other	40,308	38,451		(1,857)	(1,857)	-4.6%
	$ 251,132	$ 409,639	$ 164,415	$ (5,908)	$ 158,507	63.1%

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

The following tables are also used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of September 30, 2007 and December 31, 2006. They segregate the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position.

Investment Positions with Unrealized Losses

Segmented by Type and Period of Continuous

Unrealized Loss at September 30, 2007

(dollars in thousands)	**0-12 Mos.**	**> 12 Mos.**	**Total**
U.S Government			
Fair value	$ 909	$ 8,314	$ 9,223
Cost or Amortized Cost	926	8,391	9,317
Unrealized Loss	(17)	(77)	(94)
U.S Agency			
Fair value	$ 11,203	$ 81,256	$ 92,459
Cost or Amortized Cost	11,282	81,495	92,777
Unrealized Loss	(79)	(239)	(318)
Mtge/ABS/CMO *			
Fair value	$ 100,089	$ 112,683	$ 212,772
Cost or Amortized Cost	100,967	115,954	216,921
Unrealized Loss	(878)	(3,271)	(4,149)
Corporate			
Fair value	$ 74,283	$ 75,156	$ 149,439
Cost or Amortized Cost	76,171	78,784	154,955
Unrealized Loss	(1,888)	(3,628)	(5,516)
States, political subdivisions & revenues			
Fair value	$ 109,314	$ 78,598	$ 187,912
Cost or Amortized Cost	110,262	79,253	189,515
Unrealized Loss	(948)	(655)	(1,603)
Subtotal, debt securities			
Fair value	$ 295,798	$ 356,007	$ 651,805
Cost or Amortized Cost	299,608	363,877	663,485
Unrealized Loss	(3,810)	(7,870)	(11,680)
Common Stock			
Fair value	$ 54,669	$ 1,390	$ 56,059
Cost or Amortized Cost	57,502	1,911	59,413
Unrealized Loss	(2,833)	(521)	(3,354)
Preferred Stock			
Fair value	$ 34,154	$	$ 34,154
Cost or Amortized Cost	36,708		36,708
Unrealized Loss	(2,554)		(2,554)
Total			
Fair value	$ 384,621	$ 357,397	$ 742,018
Cost or Amortized Cost	393,818	365,788	759,606
Unrealized Loss	(9,197)	(8,391)	(17,588)

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

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Investment Positions with Unrealized Losses

Segmented by Type and Period of Continuous

Unrealized Loss at December 31, 2006

(dollars in thousands)	0-12 Mos.	> 12 Mos.	Total
U.S Government			
Fair value	$ 1,850	$ 8,994	$ 10,844
Cost or Amortized Cost	1,856	9,296	11,152
Unrealized Loss	(6)	(302)	(308)
U.S Agency			
Fair value	$ 113,858	$ 147,103	$ 260,961
Cost or Amortized Cost	114,245	148,987	263,232
Unrealized Loss	(387)	(1,884)	(2,271)
Mtge/ABS/CMO *			
Fair value	$ 69,800	$ 129,598	$ 199,398
Cost or Amortized Cost	70,108	132,874	202,982
Unrealized Loss	(308)	(3,276)	(3,584)
Corporate			
Fair value	$ 59,079	$ 86,074	$ 145,153
Cost or Amortized Cost	59,629	89,620	149,249
Unrealized Loss	(550)	(3,546)	(4,096)
States, political subdivisions & revenues			
Fair value	$ 117,351	$ 99,216	$ 216,567
Cost or Amortized Cost	117,765	100,659	218,424
Unrealized Loss	(414)	(1,443)	(1,857)
Subtotal, debt securities			
Fair value	$ 361,938	$ 470,985	$ 832,923
Cost or Amortized Cost	363,603	481,436	845,039
Unrealized Loss	(1,665)	(10,451)	(12,116)
Common Stock			
Fair value	$ 12,519	$	$ 12,519
Cost or Amortized Cost	13,046		13,046
Unrealized Loss	(527)		(527)
Total			
Fair value	$ 374,457	$ 470,985	$ 845,442
Cost or Amortized Cost	376,649	481,436	858,085
Unrealized Loss	(2,192)	(10,451)	(12,643)

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

The following table shows the composition of the fixed income securities in unrealized loss positions at September 30, 2007 by the National Association of Insurance Commissioners (NAIC) rating and the generally equivalent S&P and Moody s ratings. Not all of the securities are rated by S&P and/or Moody s.

NAIC Rating	Equivalent S&P Rating	Equivalent Moody s Rating	(dollars in thousands) Book Value	Fair Value	Unrealized Loss	Percent to Total
1	AAA/AA/A	Aaa/Aa/A	$ 625,649	$ 615,218	$ (10,431)	89.3%
2	BBB	Baa	37,836	36,587	(1,249)	10.7%
3	BB	Ba	0	0	0	
4	B	B	0	0	0	
5	CCC or lower	Caa or lower	0	0	0	
6			0	0	0	
		Total	$ 663,485	$ 651,805	$ (11,680)	100.0%

The fixed income portfolio contained 369 unrealized loss positions as of September 30, 2007. The $11.7 million in associated unrealized losses for these 369 securities is 0.8% of the fixed income portfolio s cost basis. Of these 369 securities, 177 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent $7.9 million in unrealized losses (0.6% of total fixed income portfolio s cost basis). None of the fixed income securities were in a loss position of 20% or more and no individual security was in a significant unrealized loss position. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. The fixed income unrealized losses can primarily be attributed to an increase in medium and long-term interest rates since the purchase of many of these fixed income securities. We continually monitor the credit quality of our fixed income investments to gauge our ability to be repaid principal and interest. We consider price declines of securities in our other-than-temporary-impairment analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

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

1. Credit ratings from major rating agencies, including Moody s and Standard & Poor s,
2. Business and operating performance trends,
3. Management quality/turnover,
4. Industry competitive analysis, and
5. Changes in business model/strategy.

As of September 30, 2007, we held 14 common stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled $3.4 million. Of these 14 common stock positions that were in an unrealized loss position, 13 of these securities have been in an unrealized loss position for less than twelve months. The equity security which has been in an unrealized loss position for more than 12 months exhibits attractive valuation metrics, and we continue to believe the stock will appreciate to its cost basis.

As of September 30, 2007, we held 27 preferred stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled $2.6 million. All of these securities have been in an unrealized loss position for less than twelve months.

Based on our evaluation of equity securities held within specific industry sectors, as well as the duration and magnitude of unrealized losses in our equity and bond portfolios, we do not believe any securities suffered an other-than-temporary decline in value as of September 30, 2007.

INCOME TAXES

Our effective tax rate for the first nine months of 2007 was 31% compared to 26% for the same period in 2006. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2007 is higher as the largest component of our pre-tax earnings, underwriting income, is taxed at 35% and has advanced significantly in 2007. The 2007 results include a tax benefit of $2.4 million which was recorded in the third quarter to reflect the benefit expected to be realized upon the future payment of certain accrued compensation. The 2006 results include a favorable resolution of a tax examination with an associated $3.2 million tax benefit.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the first nine months of 2007 and 2006 as a result of the following:

	2007			2006		
(in thousands)		**Amount**	**%**		**Amount**	**%**
Provision for income taxes at the Statutory rate of 35%	$	72,919	35%	$	37,566	35%
Increase (reduction) in taxes resulting from:						
Tax exempt interest income		(4,756)	-2%		(4,423)	-4%
Dividends received deduction		(1,361)	-1%		(1,427)	-1%
Dividends paid deduction		(355)	0%		(353)	-1%
Nonrecurring tax benefit		(2,356)	-1%		(3,171)	-3%
Other items, net		340	0%		183	0%
Total tax expense	$	64,431	31%	$	28,375	26%

LIQUIDITY AND CAPITAL RESOURCES

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

The following table summarizes cash flows for the nine month periods ended September 30, 2007 and 2006.

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		2007		2006
		(in thousands)		
Operating cash flows	$	111,228	$	142,765
Investing cash flows	$	(88,385)	$	(55,003)
Financing cash flows	$	(22,843)	$	(87,762)
Total	$		$	

Cash flows from operating activities decreased during the first nine months of 2007 compared to that reported for the same period in 2006, due to the timing of certain reinsurance, claim, and other payments. In both 2007 and 2006, available operating cash flow has been used in investing activities to purchase additional investment securities and to fund the repurchase of our stock. On February 10, 2006, we announced a stock repurchase program for up to $100.0 million in RLI common stock. During the first quarter of 2007, we repurchased 333,494 shares at an average cost of $56.77 per share ($18.9 million). This completed the buyback program at an overall average per share cost of $51.08. On May 3, 2007, we announced another stock repurchase program for up to $100.0 million in RLI common stock. During the third quarter of 2007, we repurchased 547,100 shares at an average price of $58.52 ($32.0 million). Since this $100 million share buyback authorization, we have repurchased 787,100 shares for a total of $45.8 million.

We have $100.0 million in long-term debt outstanding. On December 12, 2003, we completed a public debt offering, issuing $100.0 million in senior notes maturing January 15, 2014 (a 10-year maturity), and paying interest semi-annually at the rate of 5.95% per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of $98.9 million. As of September 30, 2007, we are party to reverse repurchase agreements (short-term debt) totaling $52.6 million, with an annual interest rate of 4.95%.

We are not party to any off-balance sheet arrangements.

At September 30, 2007, we had short-term investments and other investments maturing within one year, of approximately $94.9 million and investments of $427.1 million maturing within five years. We maintain revolving lines of credit with two financial institutions, each of which permits us to borrow up to an aggregate principal amount of $10.0 million. Under certain conditions, each of the lines may be increased up to an aggregate principal amount of $20.0 million. The facilities have three-year terms that expire on May 31, 2008. As of September 30, 2007, no amounts were outstanding on these facilities.

We believe that cash generated by operations, cash generated by investments and cash available from financing activities will provide sufficient sources of liquidity to meet our anticipated needs over the next 12 to 24 months.

We maintain a well-diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of September 30, 2007, our investment portfolio had a book value of $1.9 billion. Invested assets at September 30, 2007, increased by $92.9 million from December 31, 2006.

As of September 30, 2007, our fixed-income portfolio had the following rating distribution:

AAA	**80.7%**
AA	**8.0%**
A	**7.7%**
BBB	**3.6%**
Total	**100.0%**

As of September 30, 2007, the duration of the fixed income portfolio was 4.4 years. Our fixed-income portfolio remained well diversified, with 778 individual issues as of September 30, 2007.

At September 30, 2007, our equity portfolio had a fair value of $370.4 million and is also a source of liquidity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance and real estate investment trust (REIT) securities. Our preferred stock portfolio had a fair value of $39.3 million as of September 30, 2007. In the equity and preferred stock portfolios, the strategy remains one of value investing, with security selection taking precedence over market timing. We use a buy-and-hold strategy, minimizing both transactional costs and taxes.

As of September 30, 2007, our equity portfolio had a dividend yield of 2.7% compared to 1.7% for the S&P 500 index. Because of the corporate-dividend-received deduction applicable to our dividend income, we pay an effective tax rate of only 14.2% on dividends, compared to 35.0% on taxable interest and REIT income and 5.3% on municipal bond interest income. As with our bond portfolio, we maintain a well-diversified group of 133 equity securities.

Our capital structure is comprised of equity and debt outstanding. As of September 30, 2007, our capital structure consisted of $100.0 million in 10-year maturity senior notes maturing in 2014 (long-term debt), $52.6 million in reverse repurchase debt agreements with a maturity of two months, and $820.2 million of shareholders equity. Debt outstanding comprised 18.6% of total capital as of September 30, 2007.

We paid a quarterly cash dividend of $0.22 per share on October 15, 2007, the same as the prior quarter, representing our 125th consecutive quarterly dividend. Our dividend growth has averaged 19.6% annually over the last five years, and has averaged 13.9% annually over the last 10 years. We have increased dividends for 32 straight years.

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 authority of Illinois. The maximum dividend distribution is limited by Illinois law to the greater of 10% of RLI Insurance Company s policyholder surplus as of December 31 of the preceding year, or its statutory net income for the 12-month period ending December 31 of the preceding year. The limitation for 2007, based on these criteria is $75.7 million. A need existed to move additional capital to RLI Corp. from RLI Insurance Company to provide cash for the share repurchase plan, shareholder dividends, and interest on senior notes; therefore, permission for a special dividend in the amount of $50 million was sought and obtained from the Illinois Department of Insurance in the third quarter, 2007. This dividend was paid on September 24, 2007, bringing the total dividend paid from

insurance subsidiaries in the first nine months of 2007 to a total of $114.7 million. Any additional dividends for 2007 will again require approval from the Illinois Department of Insurance.

Interest and fees on debt obligations totaled $5.0 million for the first nine months of 2007, down $0.1 million from the same period in 2006. As of September 30, 2007, outstanding debt balances totaled $152.6 million, compared to $127.0 million at September 30, 2006. The September 30, 2007 debt balance is comprised of the $100.0 million in senior notes and $52.6 million in reverse repurchase agreements. The December 31, 2006 balance of $127.0 million consisted of $100.0 million in senior notes and $27.0 in reverse repurchase agreements. We have incurred interest expense on debt at the following average interest rates for the nine month periods ended September 30, 2007 and 2006:

	3Q 2007	**3Q 2006**
Line of Credit	NA	NA
Reverse repurchase agreements	5.28%	4.95%
Total short-term debt	5.28%	4.95%
Senior Notes	6.02%	6.02%
Total Debt	5.94%	5.92%

THREE MONTHS ENDED SEPTEMBER 30, 2007, COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2006

Consolidated revenues, as displayed in the table that follows, totaled $158.3 million for the third quarter of 2007 compared to $159.4 million for the same period in 2006.

	For the Three-Month Period Ended September 30,			
Consolidated revenues (in thousands)		**2007**		**2006**
Net premiums earned	$	134,111	$	138,245
Net investment income		20,433		18,316
Net realized investment gains		3,822		2,822
Total consolidated revenue	$	158,366	$	159,383

Consolidated revenue for the third quarter of 2007 decreased $1.0 million, or 1%, from the same period in 2006. Net premiums earned for the Group decreased 3% from 2006 levels, as overall writings continue to decline. Net realized investment gains increased $1.0 million to $3.8 million due in part to the timing of the sale of individual securities. Net investment income improved 11.6% to $20.4 million. This improvement is due to an increased asset base.

Net after-tax earnings for the third quarter of 2007 totaled $61.5 million, $2.56 per diluted share, compared to $30.4 million, $1.21 per diluted share, for the same period in 2006. In 2007, favorable development on prior years loss reserves resulted in additional pretax earnings of $51.3 million. This reduction in carried reserves, primarily on the casualty and surety segments, is further detailed in Determination of Our Best Estimate on pages 21 through 23 of this document. In 2006, positive development on prior years hurricane and casualty loss reserves resulted in additional pretax earnings of $12.3 million.

Bonus and profit sharing-related expenses related to these specific items totaled $3.7 million in 2007 and $1.1 million in 2006. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital). In addition, general corporate expense includes an additional $1.0 million charitable contribution in 2007.

During the third quarter of 2007, equity in earnings of unconsolidated investees totaled $2.0 million, all related to Maui Jim, Inc. The third quarter of 2006 reflected $4.7 million in investee earnings, which included $2.8 million related to Maui Jim, Inc. and $1.9 million from Taylor, Bean & Whitaker Mortgage Corp. (TBW). In the third quarter of 2006, investee earnings from Maui Jim, Inc. included a $0.8 million gain from the sale of discontinued operations. In the fourth quarter of 2006, we sold our equity interest in TBW.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled $71.4 million, $2.97 per diluted share, for the third quarter of 2007, compared to comprehensive earnings of $55.6 million, $2.21 per diluted share, for the same period in 2006. Unrealized gains, net of tax, for the third quarter of 2007 were $9.9 million, compared to $25.2 million for the same period in 2006.

Falling interest rates contributed to a decrease in unrealized gains in the fixed income portfolio in the third quarter of 2007. While the equity portfolio exhibited a positive return in the third quarter of 2007, gains totaling $3.8 million were realized in the period. This move from unrealized to realized gains reduced unrealized gains on the equity portfolio.

RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group declined to $188.3 million for the third quarter of 2007 from $212.0 million in the third quarter of 2006, primarily attributable to a decrease in casualty and property writings. Underwriting income for the Group advanced $45.0 million to pre-tax income of $66.4 million for the third quarter of 2007. Results for both years were favorably impacted by prior accident years loss and hurricane reserve releases. The GAAP combined ratio totaled 50.6 in 2007, compared to 84.5 in 2006. The decline in the combined ratio was primarily attributable to a significant decrease in the Group s loss ratio. The Group s loss ratio decreased to 12.7 for 2007, compared to 50.6 for 2006. The loss ratio in 2007 included a greater amount of favorable development on prior accident years reserves and improved performance of our property segment.

	For the Three-Month Period Ended September 30, 2007	2006
Gross premiums written (in thousands)		
Casualty	$ 114,279	$ 128,610
Property	55,551	65,102
Surety	18,488	18,302
Total	$ 188,318	$ 212,014
Underwriting income (in thousands)		
Casualty	$ 47,555	$ 18,711
Property	8,158	194
Surety	10,654	2,429
Total	$ 66,367	$ 21,334
Combined ratio		
Casualty	43.5	78.4
Property	76.0	99.5
Surety	32.8	83.8
Total	50.6	84.5

Casualty

Gross premiums written for the casualty segment totaled $114.3 million for the third quarter of 2007, a decrease of $14.3 million, or 11%, from the same period last year. This decrease is primarily attributable to continuing rate softening in the casualty segment. General liability, our largest growth contributor over the past several years, posted gross writings of $41.1 million, a decrease of $4.3 million, or 10%, from the same period last year. While rates have continued to deteriorate, this coverage has sustained profitable results. Transportation totaled $17.5 million, a decrease of $6.2 million, or 26%, from the third quarter of 2006, due to continuing price and volume declines. Executive products reported gross premiums written of $12.5 million in the third quarter of 2007, a decline of $5.0 million, or 29%, from the same period last year. On a positive note, gross premiums written for specialty program business advanced 8% to $8.9 million and personal umbrella rose 5% to $15.3 million from the same period in 2006. Despite the overall rate softening, margins remain positive and we continue to find profitable opportunities. As the casualty market continues to soften, we will remain focused on growing areas that provide the best return, while maintaining strict adherence to underwriting discipline.

In total, the casualty segment posted underwriting income of $47.6 million, compared to $18.7 million for the same period last year. Results for 2007 include favorable development on prior accident years loss reserves (predominately 2004 through 2006) for general liability, umbrella, transportation and employers indemnity. Due to this positive emergence and continued improvement in loss reporting patterns, during the third quarter of 2007, we released reserves. These reserve releases improved the segment s underwriting results by $44.3 million. From a comparative standpoint, results for 2006 included $11.7 million of favorable experience on prior accident years (1996-2003), primarily from executive products and general liability, and on hurricanes (2005). Overall, the combined ratio for the casualty segment was 43.5 for the third quarter of 2007 compared to 78.4 for the same period in 2006. The segment s loss ratio was 10.2 in the third quarter of 2007 compared to 49.8 for the same period in 2006, primarily driven by the release of prior accident years reserves. The expense ratio for the casualty segment was 33.3 for the third quarter of 2007 compared to 28.6 for the same period of 2006. The increase is primarily attributed to an increase in policy acquisition costs, which include, among other things, performance-related expenses such as bonus and profit sharing-related expenses.

Property

Gross premiums written for the property segment totaled $55.6 million for the third quarter of 2007, a decrease of $9.6 million, or 15%, from the same period last year. Our domestic fire book posted $20.3 million in gross written premiums, a decline of $8.6 million, or 30%, from the third quarter of 2006, as increased competition for non-catastrophe exposed accounts, combined with the softening of rates for coastal wind-exposed risks, have impacted the overall market. Offsetting this decline, our marine division reported $12.9 million in gross written premium during the third quarter of 2007, an increase of $3.9 million, or 43%, from the same period last year.

Underwriting income for the segment was $8.2 million for the third quarter of 2007, compared to $0.2 million for the same period in 2006. Both periods benefited from light hurricane seasons. In addition, results for 2007 include a decline in losses from tornadoes and hailstorms, as well as lowered frequency and severity of commercial fire and construction losses. Additionally, while the segment benefited in 2006 from a light hurricane season, other catastrophe losses, such as tornadoes and hailstorms, along with increased severity of commercial fire losses, negatively impacted results for 2006.

Segment results for the second quarter of 2007 translate into a combined ratio of 76.0, compared to 99.5 for the same period last year. The segment s loss ratio declined to 39.3 from 64.7 in 2006, due to the aforementioned favorable development and improved loss activity in 2007.

From an expense standpoint, the segment s expense ratio for the third quarter increased slightly to 36.7 in 2007 from 34.8 in 2006.

Surety

The surety segment posted gross premiums written of $18.5 million for the third quarter of 2007, an increase of $0.2 million, or 1%, from the same period last year. Premium growth was experienced in the energy and miscellaneous lines. The segment posted underwriting income in the third quarter of $10.7 million, compared to an income of $2.4 million for the same period last year.

Results for 2007 reflect improved loss reporting patterns for contract, commercial, energy and miscellaneous surety. Due to this positive experience, during the third quarter of 2007, we released reserves. These reserve releases, primarily from accident years 2004 through 2006, improved the segment s underwriting results by $7.9 million.

The combined ratio for the surety segment totaled 32.8 in the third quarter of 2007, versus 83.8 for the same period in 2006. The segment s loss ratio was (31.6) for 2007, compared to 21.1 for 2006, as favorable loss trends have

resulted in a reduction in carried reserves. The expense ratio increased slightly to 64.4 compared to 62.7 for the same period last year.

INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net dividend and interest income of $20.4 million during the third quarter of 2007, an increase of 11.6% over that reported for the same period in 2006. The improvement in income is due to an increased asset base and higher yields. On an after-tax basis, investment income increased by 10.6%.

Yields on our fixed income investments for the third quarter of 2007 and 2006 are as follows:

	3Q 2007	3Q 2006
Pretax Yield		
Taxable	5.46%	5.26%
Tax-Exempt	4.04%	3.99%
After-tax yield		
Taxable	3.55%	3.42%
Tax-Exempt	3.83%	3.78%

We realized $3.8 million in capital gains in the third quarter of 2007, compared to capital gains of $ 2.8 million in the third quarter of 2006. Investment gains in 2007 relate to the sale of certain equity securities deemed to have reached their full value. Funds received were used to further diversify the investment portfolio.

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

INCOME TAXES

Our effective tax rate for the third quarter of 2007 was 30% compared to 30% for the same period in 2006. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the third quarter of 2007 is the same due to an increase in underwriting income, which is taxed at 35% but offset by a nonrecurring tax benefit of $2.4 million related to the benefit expected to be realized upon the future payment of certain accrued compensation.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the third quarter of 2007 and 2006 as a result of the following:

		2007		2006	
(in thousands)		**Amount**	**%**	**Amount**	**%**
Provision for income taxes at the Statutory rate of 35%	$	30,574	35%	$ 15,247	35%
Increase (reduction) in taxes resulting from:					
Tax exempt interest income		(1,792)	-2%	(1,442)	-3%
Dividends received deduction		(501)	-1%	(490)	-2%
Dividends paid deduction		(118)	0%	(117)	0%
Nonrecurring tax benefit		(2,356)	-2%	0	0%
Other items, net		9	0%	(14)	0%
Total tax expense	$	25,816	30%	$ 13,184	30%

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk is the risk of economic losses due to adverse changes in the estimated fair value of a financial instrument as the result of changes in equity prices, interest rates, foreign exchange rates and commodity prices. Our consolidated balance sheets include assets and liabilities whose estimated fair values are subject to market risk. The primary market risks are equity price risk associated with investments in equity securities and interest rate risk associated with investments in fixed maturities. From time to time, equity prices and interest rates fluctuate causing an effect on our investment portfolio. We have no exposure to foreign exchange risk and no direct commodity risk.

Our market risk exposures at September 30, 2007, have not materially changed from those identified in our 2006 Annual Report on Form 10-K.

ITEM 4. Controls and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures was performed, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective, as of the end of the period covered by this report.

In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objective, and management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. We believe that our disclosure controls and procedures provide such reasonable assurance.

No changes were made to our internal control over financial reporting during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

On August 14, 2007, we reached a confidential settlement agreement with Ameriana Bank related to the Commercial Money Center (CMC) litigation previously disclosed in various SEC filings, including Item 3 - Legal Proceedings of our 2006 Annual Report on Form 10-K. This settlement ends our litigation with Ameriana Bank, but does not resolve our pending litigation with the remaining two investor banks. The settlement with Ameriana Bank relates to surety bonds representing approximately 14% of the amount to which the investor banks had claimed entitlement. The settlement did not have a material adverse effect on the Company s financial position or on our financial statements taken as a whole. While it is impossible to ascertain the ultimate outcome of the litigation between RLI and the remaining two investor banks at this time, we continue to believe we have meritorious defenses with respect to each of the banks making claims against us and will continue to vigorously assert those defenses in the pending litigation.

Item 1A. Risk Factors There were no material changes to report.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Items 2(a) and (b) are not applicable.

Our current common stock repurchase program, which authorizes us to repurchase up to $100 million of our Company s common stock, was approved by our Board of Directors in May 2007. The repurchase program may be suspended or discontinued at any time without prior notice. During the third quarter of fiscal year 2007, we repurchased 547,100 shares for $32.0 million under the plan. The transactions occurred pursuant to open market purchases.

The table below shows our repurchases of the Company s common stock during the third quarter of fiscal 2007.

Period	Total Number of Shares Purchased		Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program		Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program
July 1, 2007- July 31, 2007	85,300	$	58.46	85,300	$	81,276,719
August 1, 2007-August 31, 2007	461,800		58.53	461,800		54,247,449
September 1, 2007- September 30, 2007						54,247,449
Total	547,100			787,100	$	54,247,449

Item 3. **Defaults Upon Senior Securities** - Not Applicable

Item 4. **Submission of Matters to a Vote of Security Holders** - Not Applicable

Item 5. **Other Information** - Not Applicable

Item 6. **Exhibits**

Exhibit 31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

RLI Corp.

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/s/Joseph E. Dondanville
Joseph E. Dondanville
Sr. Vice President, Chief Financial Officer
(Principal Financial and
Chief Accounting Officer)

Date: October 31, 2007