RLI CORP
Form 10-Q
July 26, 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 **June 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 incorporation or organization)	(I.R.S. Employer 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 July 19, 2007 the number of shares outstanding of the registrant s Common Stock was 23,803,185.

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 June 30, 2007	2006
Net premiums earned	$ 137,488	$ 125,867
Net investment income	19,077	17,556
Net realized investment gains	14,967	1,489
	171,532	144,912
Losses and settlement expenses	51,572	74,966
Policy acquisition costs	36,827	34,207
Insurance operating expenses	9,988	9,736
Interest expense on debt	1,545	1,710
General corporate expenses	2,163	1,654
	102,095	122,273
Equity in earnings of unconsolidated investees	4,410	4,867
Earnings before income taxes	73,847	27,506
Income tax expense	23,994	4,584
Net earnings	$ 49,853	$ 22,922
Other comprehensive earnings (loss) net of tax	(14,952)	(8,199)
Comprehensive earnings	$ 34,901	$ 14,723
Earnings per share:		
Basic:		
Basic net earnings per share	$ 2.09	$ 0.91
Basic comprehensive earnings per share	$ 1.46	$ 0.59
Diluted:		
Diluted net earnings per share	$ 2.04	$ 0.89
Diluted comprehensive earnings per share	$ 1.43	$ 0.57
Weighted average number of common shares outstanding		
Basic	23,905	25,157
Diluted	24,446	25,762
Cash dividends declared per common share	$ 0.22	$ 0.19

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	**For the Six-Month Period Ended June 30**	
	2007	**2006**
Net premiums earned	$ 275,465	$ 253,254
Net investment income	38,067	34,264
Net realized investment gains	19,592	5,931
	333,124	293,449
Losses and settlement expenses	114,632	141,643
Policy acquisition costs	76,591	69,806
Insurance operating expenses	19,544	18,937
Interest expense on debt	3,055	3,392
General corporate expenses	4,040	3,509
	217,862	237,287
Equity in earnings of unconsolidated investees	5,723	7,607
Earnings before income taxes	120,985	63,769
Income tax expense	38,615	15,191
Net earnings	$ 82,370	$ 48,578
Other comprehensive earnings (loss) net of tax	(14,352)	(11,794)
Comprehensive earnings	$ 68,018	$ 36,784
Earnings per share:		
Basic:		
Basic net earnings per share	$ 3.43	$ 1.92
Basic comprehensive earnings per share	$ 2.83	$ 1.45
Diluted:		
Diluted net earnings per share	$ 3.35	$ 1.86
Diluted comprehensive earnings per share	$ 2.77	$ 1.41
Weighted average number of common shares outstanding		
Basic	24,024	25,357
Diluted	24,562	26,050
Cash dividends declared per common share	$ 0.42	$ 0.36

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)	**June 30, 2007** (unaudited)	**December 31, 2006**
ASSETS		
Investments		
Fixed maturities		
Available-for-sale, at fair value	$ 1,288,799	$ 1,234,571
Held-to-maturity, at amortized cost	95,147	106,310
Trading, at fair value	14,831	14,960
Equity securities, at fair value	365,483	368,195
Preferred stock, at fair value	28,020	
Short-term investments, at cost	103,736	104,205
Total investments	1,896,016	1,828,241
Accrued investment income	18,556	18,628
Premiums and reinsurance balances receivable	123,308	126,021
Ceded unearned premium	83,385	97,596
Reinsurance balances recoverable on unpaid losses	517,310	525,671
Deferred policy acquisition costs	77,137	73,817
Property and equipment	19,647	20,590
Investment in unconsolidated investees	36,482	36,667
Goodwill and indefinite-lived intangibles	26,214	26,214
Other assets	9,878	17,851
TOTAL ASSETS	$ 2,807,933	$ 2,771,296
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Unpaid losses and settlement expenses	$ 1,321,702	$ 1,318,777
Unearned premiums	374,441	387,811
Reinsurance balances payable	83,663	85,046
Notes payable, short-term debt	26,961	
Income taxes-current	7,661	8,318
Income taxes-deferred	21,118	27,069
Bonds payable, long-term debt	100,000	100,000
Other liabilities	88,123	87,755
TOTAL LIABILITIES	$ 2,023,669	$ 2,014,776
Shareholders' Equity		
Common stock ($1 par value)		
(31,756,283 shares issued at 6/30/07)		
(31,689,740 shares issued at 12/31/06)	31,756	31,690
Paid-in capital	189,980	187,632
Accumulated other comprehensive earnings	90,792	105,145
Retained earnings	666,497	594,147
Deferred compensation	7,576	7,744
Less: Treasury shares at cost		
(7,990,256 shares at 6/30/07)	(202,337)	(169,838)
(7,416,762 shares at 12/31/06)		
TOTAL SHAREHOLDERS' EQUITY	784,264	756,520
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	$ 2,807,933	$ 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 Six-Month Period Ended June 30, 2007**	**2006**
Net cash provided by operating activities	$ 89,047	$ 68,496
Cash Flows from Investing Activities		
Investments purchased	(230,028)	(338,875)
Investments sold	94,842	302,670
Investments called or matured	61,650	51,256
Net change in short term investments	(8,183)	(24,132)
Changes in notes receivable	6,000	
Net property and equipment purchased	(388)	(2,162)
Net cash used in investing activities	$ (76,107)	$ (11,243)
Cash Flows from Financing Activities		
Cash dividends paid	$ (9,647)	$ (8,678)
Payment on short-term debt		(267)
Proceeds from issuance of short-term debt	26,961	35
Stock option plan share issuance	2,256	3,710
Excess tax benefit from exercise of stock options	158	1,109
Treasury shares purchased	(32,668)	(53,162)
Net cash used in financing activities	$ (12,940)	$ (57,253)
Net increase in cash		
Cash at the beginning of the year		
Cash at June 30	$	$

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - The financial information is prepared in conformity with U.S. generally accepted accounting principles (GAAP), and such principles are applied on a basis consistent with those reflected in our 2006 annual report filed with the Securities and Exchange Commission. Management has prepared the financial information included herein without audit by independent registered public accountants. The condensed consolidated balance sheet as of December 31, 2006 has been derived from, but does not include all the disclosures contained in, the audited consolidated financial statements for the year ended December 31, 2006.

The information furnished includes all adjustments and normal recurring accrual adjustments that are, in the opinion of management, necessary for a fair statement of results for the interim periods. Results of operations for the three and six month periods ended June 30, 2007 and 2006 are not necessarily indicative of the results of a full year.

The accompanying financial data should be read in conjunction with the notes to the financial statements contained in our 2006 Annual Report on Form 10-K.

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 condensed financial statements.

	For the Six-Month Period Ended June 30, 2007			**For the Six-Month Period Ended June 30, 2006**		
(in thousands, except per share data)	**Income (Numerator)**	**Shares (Denominator)**	**Per Share Amount**	**Income (Numerator)**	**Shares (Denominator)**	**Per Share Amount**
Basic EPS						
Income available to common shareholders	$ 82,370	24,024	$ 3.43	$ 48,578	25,357	$ 1.92
Effective of Dilutive Securities						
Incentive Stock Options	0	538		0	693	
Diluted EPS						
Income available to common shareholders	$ 82,370	24,562	$ 3.35	$ 48,578	26,050	$ 1.86

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(in thousands, except per share data)	For the Three-Month Period Ended June 30, 2007 Income (Numerator)	Shares (Denominator)	Per Share Amount	For the Three-Month Period Ended June 30, 2006 Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 49,853	23,905	$ 2.09	$ 22,922	25,157	$ 0.91
Effective of Dilutive Securities						
Incentive Stock Options	0	541		0	605	
Diluted EPS						
Income available to common shareholders	$ 49,853	24,446	$ 2.04	$ 22,922	25,762	$ 0.89

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

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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 six months ended June 30, 2006, we incurred $913,000 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 June 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 six months of 2007 and $0.2 million for the same period of 2006. At June 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 may 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	(68,191)	$ 22.88		$ 2,315
Options canceled/forfeited	(4,580)	$ 50.30		
Outstanding options at June 30 2007	1,775,548	$ 34.59	5.83	$ 37,931
Exercisable options at June 30, 2007	1,394,687	$ 29.40	4.85	$ 37,033

	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	176,900	$ 50.21		
Options exercised	(289,690)	$ 20.20		$ 9,627
Options canceled/forfeited	(2,900)	$ 34.64		
Outstanding options at June 30, 2006	1,815,937	$ 29.83	5.79	$ 33,316
Exercisable options at June 30, 2006	1,639,037	$ 27.63	5.35	$ 33,676

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 $0.8 million of expense in the first six months of 2007 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of $0.3 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was $4.0 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 June 30:

	2007	2006
Weighted-average fair value of grants	$ 15.12	$ 13.99
Risk-free interest rates	4.60 %	5.03 %
Dividend yield	1.47 %	1.51 %
Expected volatility	21.72 %	22.44 %
Expected option life	6.34 years	6.31 years

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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)

SEGMENT DATA (in thousands)	**For the Three-Month Periods Ended June 30, REVENUES**		**For the Six-Month Periods Ended June 30, REVENUES**	
	2007	**2006**	**2007**	**2006**
Casualty	$ 87,784	$ 85,815	$ 175,799	$ 173,081
Property	34,486	25,370	69,095	50,992
Surety	15,218	14,682	30,571	29,181
Segment totals before income taxes	$ 137,488	$ 125,867	$ 275,465	$ 253,254
Net investment income	19,077	17,556	38,067	34,264
Net realized gains	14,967	1,489	19,592	5,931
Total	$ 171,532	$ 144,912	$ 333,124	$ 293,449
	NET EARNINGS		**NET EARNINGS**	
	2007	**2006**	**2007**	**2006**
Casualty	$ 25,268	$ 6,635	$ 43,885	$ 15,521
Property	8,791	(1,774)	12,740	3,304
Surety	5,042	2,097	8,073	4,043
Net Underwriting Income	$ 39,101	$ 6,958	$ 64,698	$ 22,868
Net investment income	19,077	17,556	38,067	34,264
Net realized gains	14,967	1,489	19,592	5,931
General corporate expense and interest on debt	(3,708)	(3,364)	(7,095)	(6,901)
Equity in earnings of unconsolidated investee	4,410	4,867	5,723	7,607
Total earnings before income taxes	$ 73,847	$ 27,506	$ 120,985	$ 63,769
Income tax expense	23,994	4,584	38,615	15,191
Total	$ 49,853	$ 22,922	$ 82,370	$ 48,578

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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 June 30, 2007	2006	For the Six-Month Periods Ended June 30, 2007	2006
Casualty				
General liability	$ 42,647	$ 44,440	$ 86,646	$ 89,347
Commercial and personal umbrella	16,607	16,069	33,328	31,765
Commercial transportation	12,793	11,961	25,126	24,475
Specialty program business	7,490	5,895	14,497	12,786
Executive coverages	3,150	3,123	6,152	6,183
Other	5,097	4,327	10,050	8,525
Total	$ 87,784	$ 85,815	$ 175,799	$ 173,081
Property				
Commercial property	$ 23,513	$ 21,329	$ 48,300	$ 39,362
Construction	774	(1,693)	1,910	1,044
Marine	7,542	3,409	13,606	6,102
Other property	2,657	2,325	5,279	4,484
Total	$ 34,486	$ 25,370	$ 69,095	$ 50,992
Surety	$ 15,218	$ 14,682	$ 30,571	$ 29,181
Grand Total	$ 137,488	$ 125,867	$ 275,465	$ 253,254

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.

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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 June 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

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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 historic 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. From time to time, we benchmark our reserving policies and procedures and update them by adopting industry best practices where appropriate. We are currently in the process of performing such a review.

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.

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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.

SIX MONTHS ENDED JUNE 30, 2007, COMPARED TO SIX MONTHS

ENDED JUNE 30, 2006

Consolidated revenues, as displayed in the table that follows, totaled $333.1 million for the first six months of 2007 compared to $293.4 million for the same period in 2006.

Consolidated revenues (in thousands)	**For the Six-Month Period Ended June 30,** 2007	2006
Net premiums earned	$ 275,465	$ 253,254
Net investment income	38,067	34,264
Net realized investment gains	19,592	5,931
Total consolidated revenue	$ 333,124	$ 293,449

Consolidated revenue for the first six months of 2007 increased $39.7 million, or 14%, from the same period in 2006. Net premiums earned for the Group increased 9% from 2006 levels, as the significant growth in property premium experienced in 2006 was earned as revenue. Net realized investment gains increased $13.7 million to $19.6 million for the first six 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 to

further diversify the investment portfolio. Net investment income improved 11% to $38.1 million. This improvement was primarily due to an increased asset base.

Net after-tax earnings for the first six months of 2007 totaled $82.4 million, $3.35 per diluted share, compared to $48.6 million, $1.86 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 loss and hurricane reserves resulted in additional pretax earnings of $36.4 million. In 2006, positive development on prior accident years loss and hurricane reserves resulted in additional pretax earnings of $5.5 million. Offsetting this favorable development in 2006 was a $7.7 million loss on construction coverages. Bonus and profit sharing-related expenses related to these specific items totaled $3.6 million in 2007 and ($0.2) 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).

During the first six months of 2007, equity in earnings of unconsolidated investees totaled $5.7 million, all related to Maui Jim, Inc. The first six months of 2006 reflected $7.6 million in investee earnings, which included $5.6 million related to Maui Jim, Inc. and $2.0 million from Taylor, Bean & Whitaker Mortgage Corp. (TBW). In the fourth quarter of 2006, we sold our equity interest in TBW.

Comprehensive earnings, which include net earnings plus unrealized gains/losses net of tax, totaled $68.0 million, $2.77 per diluted share, for the first six months of 2007, compared to comprehensive earnings of $36.8 million, $1.41 per diluted share, for the same period in 2006. Unrealized losses, net of tax, for the first six months of 2007 were $14.4 million, compared to $11.8 million for the same period in 2006.

Rising interest rates contributed to an increase in unrealized losses in the fixed income portfolio in the first six months of 2007. While the equity portfolio exhibited a positive return in the first six months of 2007, gains totaling $19.6 million were realized in the period. This move from unrealized to realized gains reduced the increase in gross unrealized gains on the equity portfolio.

RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group declined to $383.4 million for the first six months of 2007 from $403.8 million in the first six months of 2006, primarily attributable to a decrease in casualty and property writings. Underwriting income for the Group advanced $41.8 million to pre-tax income of $64.7 million for the first six months of 2007. Underwriting income for 2007 included $36.4 million in favorable development on prior accident years loss and hurricane reserves. On a comparative basis, underwriting income for 2006 of $22.9 million included $5.5 million in favorable development on prior accident years loss and hurricane reserves, offset by a $7.7 million underwriting loss on construction coverages. The GAAP combined ratio totaled 76.5 in 2007, compared to 90.9 in 2006. The decline in combined ratio was primarily attributable to a decrease in the Group s loss ratio. The Group s loss ratio decreased to 41.6 for 2007, compared to 55.9 for 2006. The loss ratio in 2007 included a greater amount

of favorable development on prior accident years reserves, as discussed above.

	For the Six-Month Period Ended June 30,	
Gross premiums written (in thousands)	**2007**	**2006**
Casualty	$ 238,607	$ 250,094
Property	108,408	120,095
Surety	36,392	33,654
Total	$ 383,407	$ 403,843
Underwriting income (in thousands)		
Casualty	$ 43,885	$ 15,521
Property	12,740	3,304
Surety	8,073	4,043
Total	$ 64,698	$ 22,868
Combined ratio		
Casualty	75.0	91.0
Property	81.5	93.5
Surety	73.6	86.2
Total	76.5	90.9

Casualty

Gross premiums written for the casualty segment totaled $238.6 million for the first six months of 2007, a decrease of $11.5 million, or 5%, from the same period last year. This decrease is primarily attributable to 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 $16.9 million for the first six months of 2007, an increase of $2.5 million, or 17%, over the same period in 2006. In addition, gross premiums written for personal umbrella was $29.6 million for the first six months of 2007, up $1.3 million, or 5%, from the same period in 2006. General liability, our largest growth contributor over the past several years, posted gross writings of $96.8 million, a decrease of $7.9 million, or 8%, from the same period last year. While rates have continued to deteriorate, this coverage has sustained profitable results. Transportation totaled $29.5 million, a decrease of $2.9 million, or 9%, from the first six 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 $43.9 million, compared to $15.5 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 (1998 through 2005) 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 six months of 2007, we released reserves. These reserve releases improved the segment s underwriting results by $33.3 million. From a comparative standpoint, results for 2006 included $2.8 million of favorable

experience on prior accident years (1996-2003), primarily from executive products, and on hurricanes (2005). Overall, the combined ratio for the casualty segment was 75.0 for 2007 compared to 91.0 in 2006. The segment s loss ratio was 45.2 in 2007 compared to 62.6 in 2006 as 2007 reserves developed more favorably.

The expense ratio for the casualty segment was 29.8 for the first six months of 2007 compared to 28.4 for the first six 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 $108.4 million, a decrease of $11.7 million, or 10%, from the same period last year. Our domestic fire book posted $45.1 million in gross written premiums, a decline of $20.9 million, or 32%, from the first six 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 $20.5 million in gross written premium during the first six months of 2007, an increase of $9.5 million, or 86%, from the same period last year.

Net premiums earned for the segment totaled $69.1 million, an increase of $18.1 million, or 36%, from the first six months of 2006 while net premiums written totaled $71.5 million, a decrease of $2.9 million, or 4%, 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 $12.7 million for the first six months of 2007, compared to $3.3 million for the same period in 2006. In 2007, favorable development on prior accident years (prior to 1999) on assumed property business and hurricanes (2005) improved the segment s underwriting results by $1.6 million. In 2006, losses and reinstatement premiums associated with the run-off of previously exited construction coverages adversely impacted results by $7.7 million. Partially offsetting these losses in 2006 was $2.7 million of hurricane reserve releases.

Segment results for 2007 translate into a combined ratio of 81.5, compared to 93.5 for the same period last year. The segment s loss ratio declined to 46.2 from 51.9 in 2006, due to the aforementioned increased loss activity in 2006.

From an expense standpoint, the segment s expense ratio improved to 35.3 from 41.6 in 2006. The expense ratio for the first six months of 2006 was 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. The net expense ratio is continuing to trend downward as anticipated.

Surety

The surety segment posted gross premiums written of $36.4 million for the first six months of 2007, an increase of $2.7 million, or 8%, from the same period last year. Premium growth was experienced across miscellaneous, commercial and energy lines. The segment posted underwriting income of $8.1

million, compared to an income of $4.0 million for the same period last year. Results for 2007 reflect marginal improvement in loss reporting patterns for commercial and miscellaneous surety. Due to this positive experience on a prior accident year (2005), during the first six months of 2007, we released reserves. These reserve releases improved the segment s underwriting results by $1.6 million.

The combined ratio for the surety segment totaled 73.6 in 2007, versus 86.2 for the same period in 2006. The segment s loss ratio was 10.5 for 2007, compared to 23.3 for 2006, as favorable loss trends have resulted in a decrease in loss booking ratios. The expense ratio increased slightly to 63.1 compared to 62.9 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. This settlement ends our litigation with Sky Bank but does not resolve our pending litigation with the remaining three investor banks. The settlement with Sky Bank relates to surety bonds representing approximately 52% of the amount to which the investor banks had claimed entitlement. The settlement 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 three 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 six months of 2007, net investment income increased by 11.1% 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 9.9%. The average annual yields on our investments for the first six months of 2007 and 2006 were as follows.

Pretax Yield	2Q 2007		2Q 2006	
Taxable	5.37	%	5.16	%
Tax-Exempt	4.02	%	3.97	%
After-tax yield				
Taxable	3.49	%	3.35	%
Tax-Exempt	3.81	%	3.76	%

The fixed-income portfolio increased by $42.9 million during the first six months of 2007. This portfolio had a tax-adjusted total return on a mark-to-market basis of 1.6%. Our equity portfolio decreased by $2.7 million during

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the first six months of 2007, to $365.5 million. The equity portfolio had a total return of 6.1% during the first six months of 2007. During the first six months of 2007, we began investing in preferred stock securities. The preferred stock portfolio had a market value of $28.0 million at 6/30/07. The preferred portfolio had a total return of -2.4% during the first six months of 2007.

We realized a total of $19.6 million in capital gains in the first six months of 2007, compared to capital gains of $5.9 million in the first six 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 six 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 June 30, 2007, including fair value, cost basis, and unrealized gains and losses.

	6/30/2007 Cost Basis (dollars in thousands)	**Fair Value**	**Gross Unrealized Gains**	**Losses**	**Net**	**Unrealized Gain/Loss % (1)**
Consumer Discretionary	$ 15,649	$ 20,830	$ 5,181	$	$ 5,181	33.1 %
Consumer Staples	16,215	32,631	16,416		16,416	101.2 %
Energy	8,447	32,045	23,598		23,598	279.4 %
Financials	24,990	55,828	31,213	(375)	30,838	123.4 %
Healthcare	14,270	30,151	16,513	(632)	15,881	111.3 %
Industrials	15,968	37,446	21,681	(203)	21,478	134.5 %
Materials	7,178	9,213	2,035		2,035	28.4 %
Information Technology	14,103	24,211	10,108		10,108	71.7 %
Telecommunications	5,159	14,403	9,244		9,244	179.2 %
Utilities	43,022	69,758	26,752	(16)	26,736	62.1 %
Preferred Stocks	28,871	28,020	13	(864)	(851)	-2.9 %
Other	39,003	38,967	15	(51)	(36)	-0.1 %
	$ 232,875	$ 393,503	$ 162,769	$ (2,141)	$ 160,628	69.0 %

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

The following table is also used as part of our impairment analysis and illustrates the total value of securities that were in an unrealized loss position as of June 30, 2007. It segregates the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The table further classifies the securities based on the length of time they have been in an unrealized loss position.

Investment Positions with Unrealized Losses

Segmented by Type and Period of Continuous

Unrealized Loss at June 30, 2007

(dollars in thousands)	**0-12 Mos.**	**> 12 Mos.**	**Total**
U.S Government			
Fair value	$ 4,517	$ 9,502	$ 14,019
Cost or Amortized Cost	4,556	9,839	14,395
Unrealized Loss	(39)	(337)	(376)
U.S Agency			
Fair value	$ 177,781	$ 158,231	$ 336,012
Cost or Amortized Cost	178,949	160,701	339,650
Unrealized Loss	(1,168)	(2,470)	(3,638)
Mtge/ABS/CMO *			
Fair value	$ 156,727	$ 114,996	$ 271,723
Cost or Amortized Cost	159,296	119,898	279,194
Unrealized Loss	(2,569)	(4,902)	(7,471)
Corporate			
Fair value	$ 110,291	$ 85,732	$ 196,023
Cost or Amortized Cost	112,687	90,073	202,760
Unrealized Loss	(2,396)	(4,341)	(6,737)
States, political subdivisions & revenues			
Fair value	$ 240,355	$ 78,487	$ 318,842
Cost or Amortized Cost	244,140	80,278	324,418
Unrealized Loss	(3,785)	(1,791)	(5,576)
Subtotal, debt securities			
Fair value	$ 689,671	$ 446,948	$ 1,136,619
Cost or Amortized Cost	699,628	460,789	1,160,417
Unrealized Loss	(9,957)	(13,841)	(23,798)
Common Stock			
Fair value	$ 49,046	$ 1,708	$ 50,754
Cost or Amortized Cost	50,120	1,911	52,031
Unrealized Loss	(1,074)	(203)	(1,277)
Preferred Stock			
Fair value	$ 26,511	$	$ 26,511
Cost or Amortized Cost	27,375		27,375
Unrealized Loss	(864)		(864)
Total			
Fair value	$ 765,228	$ 448,656	$ 1,213,884
Cost or Amortized Cost	777,123	462,700	1,239,823
Unrealized Loss	(11,895)	(14,044)	(25,939)

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

The following table shows the composition of the fixed income securities in loss positions at June 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	$1,123,322	$1,100,882	$(22,440)	94.3%
2	BBB	Baa	37,095	35,737	(1,358)	5.7%
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	$1,160,417	$1,136,619	$(23,798)	100.0%

The fixed income portfolio contained 581 unrealized loss positions as of June 30, 2007. The $23.8 million in associated unrealized losses for these 581 securities is 1.7% of the fixed income portfolio s cost basis. Of these 581 securities, 232 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent $13.8 million in unrealized losses (1.0% 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 June 30, 2007, we held 10 common stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled $1.3 million. Of these 10 common stock positions that were in an unrealized loss position, 9 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 the cost basis.

As of June 30, 2007, we held 19 preferred stock positions that were in

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unrealized loss positions. Unrealized losses on these securities totaled $0.9 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 June 30, 2007.

INCOME TAXES

Our effective tax rate for the first six months of 2007 was 32% compared to 24% for the same period in 2006. The effective rate for the first six months of 2007 is higher due to the increase in underwriting income, which is taxed at 35%. Additionally, results for 2006 include a favorable resolution of a tax examination. During the second quarter of 2006, the Internal Revenue Service (IRS) concluded an examination of our tax years 2000 through 2004. As a result of the conclusion of this exam, we recorded a $3.2 million tax benefit, resulting from a change in tax estimate related to the sale of assets. Effective rates are dependent upon components of pretax earnings and the related tax effects.

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 six months of 2007 and 2006 as a result of the following:

(in thousands)	2007 Amount	%	2006 Amount	%
Provision for income taxes at the Statutory rate of 35%	$ 42,345	35 %	$ 22,319	35 %
Increase (reduction) in taxes resulting from:				
Tax exempt interest income	(2,965)	-2 %	(2,980)	-5 %
Dividends received deduction	(859)	-1 %	(937)	-1 %
Dividends paid deduction	(237)	0 %	(235)	0 %
Tax benefit on IRS examination	0	0 %	(3,171)	-5 %
Other items, net	331	0 %	195	0 %
Total tax expense	$ 38,615	32 %	$ 15,191	24 %

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 six month periods ended June 30, 2007 and 2006.

	2007 (in thousands)	2006
Operating cash flows	$ 89,047	$ 68,496
Investing cash flows	$ (76,107)	$ (11,243)
Financing cash flows	$ (12,940)	$ (57,253)
Total	$	$

Cash flows from operating activities increased during the first six 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 second quarter of 2007, we repurchased 240,000 shares at an average cost of $57.23 per share ($13.7 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 June 30, 2007, we are party to reverse repurchase agreements (short-term debt) totaling $27.0 million, with an annual interest rate of 5.38%.

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

At June 30, 2007, we had short-term investments and other investments maturing within one year, of approximately $134.3 million and investments of $442.0 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 June 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 June 30, 2007, our investment portfolio had a book value of $1.9 billion. Invested assets at June 30, 2007, increased by $67.8 million from December 31, 2006.

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

AAA	**79.3%**
AA	**9.2%**
A	**8.1%**
BBB	**3.4%**
Total	**100.0%**

As of June 30, 2007, the duration of the fixed income portfolio was 4.85 years. Our fixed-income portfolio remained well diversified, with 776 individual issues as of June 30, 2007.

At June 30, 2007, our equity portfolio had a value of $365.5 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 market value of $28.0 million as of June 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 June 30, 2007, our equity portfolio had a dividend yield of 2.6% 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 122 equity securities.

Our capital structure is comprised of equity and debt outstanding. As of June 30, 2007, our capital structure consisted of $100.0 million in 10-year maturity senior notes maturing in 2014 (long-term debt), $27.0 million in reverse repurchase debt agreements with a maturity of three months, and $784.3 million of shareholders equity. Debt outstanding comprised 13.9% of total capital as of June 30, 2007.

We paid a quarterly cash dividend of $0.22 per share on July 13, 2007, a 10%, or two-cent, increase over the prior quarter, representing our 124th consecutive quarterly dividend. Our dividend growth has averaged 20.9% 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 net income for the 12-month period ending December 31 of the preceding year. In the first six months of 2007, a total of $64.7 million in dividends were paid from insurance subsidiaries, leaving $11 million in dividend capacity for the remainder of 2007.

Interest and fees on debt obligations totaled $3.1 million for the first six months of 2007, down $0.3 million from the same period in 2006. As of June 30, 2007, outstanding debt balances totaled $127.0 million, compared to $115.3

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million at June 30, 2006. The June 30, 2007 debt balance is comprised of the $100.0 million in senior notes and $27.0 million in reverse repurchase agreements. The June 30, 2006 balance of $115.3 million consisted of $100.0 million in senior notes and $15.3 in reverse repurchase agreements. We have incurred interest expense on debt at the following average interest rates for the six month periods ended June 30, 2007 and 2006:

	2Q 2007	2Q 2006
Line of Credit	NA	NA
Reverse repurchase agreements	5.45 %	4.83 %
Total short-term debt	5.45 %	4.83 %
Senior Notes	6.02 %	6.02 %
Total Debt	6.01 %	5.90 %

THREE MONTHS ENDED JUNE 30, 2007, COMPARED TO THREE MONTHS

ENDED JUNE 30, 2006

Consolidated revenues, as displayed in the table that follows, totaled $171.5 million for the second quarter of 2007 compared to $144.9 million for the same period in 2006.

	For the Three-Month Period Ended June 30,	
Consolidated revenues (in thousands)	**2007**	**2006**
Net premiums earned	$ 137,488	$ 125,867
Net investment income	19,077	17,556
Net realized investment gains	14,967	1,489
Total consolidated revenue	$ 171,532	$ 144,912

Consolidated revenue for the second quarter of 2007 increased $26.6 million, or 18%, from the same period in 2006. Net premiums earned for the Group increased 9% from 2006 levels, as the significant growth in property premium experienced in 2006 was earned as revenue. Net realized investment gains increased $13.5 million to $15.0 million due in part to the timing of the sale of individual securities. Net investment income improved 9% to $19.1 million. This improvement is due to an increased asset base and a higher interest rate environment.

Net after-tax earnings for the second quarter of 2007 totaled $49.9 million, $2.04 per diluted share, compared to $22.9 million, $0.89 per diluted share, for the same period in 2006. In 2007, favorable development on prior years loss and hurricane reserves resulted in additional pretax earnings of $22.8 million. In 2006, positive development on hurricane reserves resulted in additional pretax earnings of $1.5 million. Offsetting this favorable development in 2006 were losses and reinstatement premiums associated with the run-off of previously exited construction coverages, which adversely impacted results for the second quarter of 2006 by $7.7 million pretax. Bonus and profit sharing-related expenses related to these specific items totaled $2.3 million in 2007 and ($0.6) million in 2006. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are

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predominately influenced by corporate performance (operating earnings and return on capital).

During the second quarter of 2007, equity in earnings of unconsolidated investees totaled $4.4 million, all related to Maui Jim, Inc. The second quarter of 2006 reflected $4.9 million in investee earnings, which included $3.6 million related to Maui Jim, Inc. and $1.3 million from Taylor, Bean & Whitaker Mortgage Corp. (TBW). In the fourth quarter of 2006, we sold our equity interest in TBW.

Comprehensive earnings, which include net earnings plus unrealized gains/losses net of tax, totaled $34.9 million, $1.43 per diluted share, for the second quarter of 2007, compared to comprehensive earnings of $14.7 million, $0.57 per diluted share, for the same period in 2006. Unrealized losses, net of tax, for the second quarter of 2007 were $15.0 million, compared to $8.2 million for the same period in 2006.

Rising interest rates contributed to an increase in unrealized losses in the fixed income portfolio in the second quarter of 2007. While the equity portfolio exhibited a positive return in the second quarter of 2007, gains totaling $15.0 million were realized in the period. This move from unrealized to realized gains reduced the increase in gross unrealized gains on the equity portfolio.

RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group declined to $212.1 million for the second quarter of 2007 from $228.7 million in the second quarter of 2006, primarily attributable to a decrease in casualty and property writings. Underwriting income for the Group advanced $32.1 million to pre-tax income of $39.1 million for the second quarter of 2007. Results for 2007 were favorably impacted by prior accident years loss and hurricane reserve releases, while results for 2006 were negatively impacted by the underwriting loss experienced on construction coverages. The GAAP combined ratio totaled 71.6 in 2007, compared to 94.5 in 2006. The decline in the combined ratio was primarily attributable to a decrease in the Group s loss ratio. The Group s loss ratio decreased to 37.5 for 2007, compared to 59.6 for 2006. The loss ratio in 2007 included a greater amount of favorable development on prior accident years reserves, while the loss ratio for 2006 included construction losses, as discussed above.

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	For the Three-Month Period Ended June 30,	
Gross premiums written (in thousands)	**2007**	**2006**
Casualty	$ 127,250	$ 134,938
Property	66,256	77,203
Surety	18,585	16,549
Total	$ 212,091	$ 228,690
Underwriting income (in thousands)		
Casualty	$ 25,268	$ 6,635
Property	8,791	(1,774)
Surety	5,042	2,097
Total	$ 39,101	$ 6,958
Combined ratio		
Casualty	71.2	92.2
Property	74.6	107.0
Surety	66.9	85.8
Total	71.6	94.5

Casualty

Gross premiums written for the casualty segment totaled $127.3 million for the second quarter of 2007, a decrease of $7.7 million, or 6%, from the same period last year. This decrease is primarily attributable to 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 $9.7 million for the second quarter of 2007, an increase of $1.9 million, or 25%, over the same period in 2006. In addition, gross premiums written for personal umbrella totaled $15.5 million for the second quarter of 2007, up $0.7 million, or 5%, from the same period in 2006. General liability, our largest growth contributor over the past several years, posted gross writings of $49.7 million, a decrease of $5.4 million, or 10%, from the same period last year. While rates have continued to deteriorate, this coverage has sustained profitable results. 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 $25.3 million, compared to $6.6 million for the same period last year. Results for 2007 include favorable experience on prior accident years (1998 through 2005) primarily for general liability, umbrella, transportation and employers indemnity. Due to this positive emergence and continued improvement in loss reporting patterns, during the second quarter of 2007, we released reserves. These reserve releases improved the segment s underwriting results by $19.4 million. Overall, the combined ratio for the casualty segment was 71.2 for the second quarter of 2007 compared to 92.2 for the same period in 2006. The segment s loss ratio was 41.8 in the second quarter of 2007 compared to 63.7 for the same period in 2006, primarily driven by the release of prior accident years reserves. The expense ratio for the casualty segment was 29.4 for the second quarter of 2007 compared to 28.5 for the same period of 2006.

Property

Gross premiums written for the property segment totaled $66.3 million for the second quarter of 2007, a decrease of $10.9 million, or 14%, from the same period last year. Our domestic fire book posted $28.2 million in gross written premiums, a decline of $14.6 million, or 34%, from the second 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 $11.7 million in gross written premium during the second quarter of 2007, an increase of $4.9 million, or 71%, from the same period last year.

Underwriting income for the segment was $8.8 million for the second quarter of 2007, compared to an underwriting loss of $1.8 million for the same period in 2006. In the second quarter of 2007, favorable development on prior accident years (prior to 1999) on assumed property business and hurricanes (2005) improved the segment s underwriting results by $1.6 million. In the second quarter of 2006, losses and reinstatement premiums associated with the run-off of previously exited construction coverages adversely impacted results by $7.7 million. Partially offsetting these losses in 2006 was $1.2 million of hurricane reserve releases.

Segment results for the second quarter of 2007 translate into a combined ratio of 74.6, compared to 107.0 for the same period last year. The segment s loss ratio declined to 41.8 from 66.2 in 2006, due to the aforementioned increased loss activity in 2006.

From an expense standpoint, the segment s expense ratio for the second quarter improved to 32.8 in 2007 from 40.8 in 2006. The expense ratio for 2006 was 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 $18.6 million for the second quarter of 2007, an increase of $2.0 million, or 12%, from the same period last year. Premium growth was experienced across miscellaneous and commercial lines. The segment posted underwriting income in the second quarter of $5.0 million, compared to an income of $2.1 million for the same period last year. Results for 2007 reflect marginal improvement in loss reporting patterns for commercial and miscellaneous surety. Due to this positive experience on a prior accident year (2005), during the second quarter of 2007, we released reserves. These reserve releases improved the segment s underwriting results by $1.6 million.

The combined ratio for the surety segment totaled 66.9 in the second quarter of 2007, versus 85.8 for the same period in 2006. The segment s loss ratio was 3.1 for 2007, compared to 23.7 for 2006, as favorable loss trends have resulted in a decrease in loss booking ratios. The expense ratio increased slightly to 63.8 compared to 62.1 for the same period last year.

INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net dividend and interest income of $19.1 million during the second quarter of 2007, an increase of 8.7% over that reported for the same period in 2006. The improvement in income is due to an

increased asset base and a higher interest rate environment. On an after-tax basis, investment income increased by 7.9%.

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

Pretax Yield	2Q 2007		2Q 2006	
Taxable	5.33	%	5.25	%
Tax-Exempt	4.03	%	4.01	%
After-tax yield				
Taxable	3.46	%	3.41	%
Tax-Exempt	3.82	%	3.80	%

We realized $15.0 million in capital gains in the second quarter of 2007, compared to capital gains of $ 1.5 million in the second 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 second quarters of 2007 or 2006.

INCOME TAXES

Our effective tax rate for the second quarter of 2007 was 32% compared to 17% 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 second quarter of 2007 is higher due to the increase in underwriting income, which is taxed at 35%. Additionally, results for 2006 include a favorable resolution of a tax examination. During the second quarter of 2006, the Internal Revenue Service (IRS) concluded an examination of our tax years 2000 through 2004. As a result of the conclusion of this exam, we recorded a $3.2 million tax benefit, resulting from a change in tax estimate related to the sale of assets.

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 second quarter of 2007 and 2006 as a result of the following:

(in thousands)	2007 Amount	%	2006 Amount	%
Provision for income taxes at the Statutory rate of 35%	$ 25,846	35 %	$ 9,627	35 %
Increase (reduction) in taxes resulting from:				
Tax exempt interest income	(1,476)	-2 %	(1,468)	-5 %
Dividends received deduction	(417)	-1 %	(480)	-2 %
Dividends paid deduction	(117)	0 %	(119)	0 %
Tax benefit on IRS examination	0	0 %	(3,171)	-12 %
Other items, net	158	0 %	195	1 %
Total tax expense	$ 23,994	32 %	$ 4,584	17 %

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 June 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

As previously reported, RLI Corp., RLI Insurance Company and Mt. Hawley Insurance Company were defendants in a lawsuit that was seeking class-action status in federal court in New Jersey, which was brought in October 2004 against over 100 insurance brokers and insurance companies by a putative class of plaintiffs who purchased insurance from the defendants. The lawsuit alleged state and federal antitrust violations, RICO violations, breach of fiduciary duties and unjust enrichment resulting from the payment of contingent commissions by the defendant insurers to the defendant brokers. The complaint sought unspecified amounts in damages, including punitive damages, as well as other legal and equitable relief. We denied all the allegations and vigorously contested this suit.

In May 2007, we reached a settlement with the plaintiffs in which all RLI defendants were fully released from the lawsuit without payment of any damages or settlement fees.

Additionally, on June 7, 2007, we reached a confidential settlement agreement with Sky 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. The settlement ends our litigation with Sky Bank, but does not resolve our pending litigation with the remaining three investor banks. The settlement with Sky Bank relates to surety bonds representing approximately 52% 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 three 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 Not Applicable

Item 3. Defaults Upon Senior Securities Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders

At the May 3, 2007 annual shareholders meeting, the vote of the holders of outstanding shares of common stock entitled to vote was as follows:

Election of Directors

	Votes Cast For	Withheld
Barbara R. Allen	21,464,630	212,619
Richard H. Blum	21,457,943	219,306
F. Lynn McPheeters	21,456,777	220,472
Robert O. Viets	21,343,215	334,034

Ratification of Selection of Independent Registered Public Accounting Firm

Votes Cast For	Against	Abstain
21,363,565	212,838	100,843

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.

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

Date: July 26, 2007