RLI CORP
Form 10-K
February 28, 2007

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-K

**x** **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2006**

**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 No.) |
| **9025 North Lindbergh Drive, Peoria, Illinois** | **61615** |
| (Address of principal executive offices) | (Zip Code) |

Registrant s telephone number, including area code **(309) 692-1000**

Securities registered pursuant to Section 12(b) of the Act:

| **Title of each class** | **Name of each exchange on which registered** |
|---|---|
| Common Stock $1.00 par value | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: **NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes o No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

The aggregate market value of the registrant s common stock held by non-affiliates of the Registrant as of June 30, 2006, based upon the closing sale price of the Common Stock on June 30, 2006 as reported on the New York Stock Exchange, was $1,011,588,725. Shares of Common Stock held directly or indirectly by each officer and director along with shares held by the Company ESOP have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of the Registrant s Common Stock, $1.00 par value, on February 23, 2007 was 24,084,305.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the 2006 Financial Report to Shareholders for the past year ended December 31, 2006, are incorporated by reference into Parts I and II of this document.

Portions of the Registrant s definitive Proxy Statement for the 2007 annual meeting of security holders to be held May 3, 2007, are incorporated herein by reference into Part III of this document.

Exhibit index is located on pages 51-52 of this document, which lists documents incorporated by reference herein.

PART I

Item 1. **Business**

RLI Corp. underwrites selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance 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.

We maintain an Internet website at http://www.rlicorp.com. We make available free of charge on our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed with or furnished to the Securities and Exchange Commission as soon as reasonably practicable after such materials are filed.

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 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 initially wrote specialty property and casualty insurance through independent underwriting agents. We opened our first branch office in 1984, and began to shift from independent underwriting agents to wholly-owned branch offices that market to wholesale producers. We also market certain coverages to retail producers from several of our casualty, surety and property operations. We produce a limited amount of business under agreements with managing general agents under the direction of our product vice presidents. The majority of business is marketed through our branch offices located in Phoenix, Arizona; Los Angeles, California; Oakland, California; San Francisco, California; Glastonbury, Connecticut; Sarasota, Florida; Atlanta, Georgia; Alpharetta, Georgia; Honolulu, Hawaii; Chicago, Illinois; Peoria, Illinois; Indianapolis, Indiana; Boston, Massachusetts; Kansas City, Missouri; St. Louis, Missouri; Lincoln, Nebraska; Montvale, New Jersey; Summit, New Jersey; New York, New York; Saratoga Springs, New York; Cleveland, Ohio; Philadelphia, Pennsylvania; Pittsburgh, Pennsylvania; Dallas, Texas; Houston, Texas; and Seattle, Washington.

For the year ended December 31, 2006, the following table provides the geographic distribution of our risks insured as represented by direct premiums earned for all coverages. For the year ended December 31, 2006, no other state or territory accounted for 1.5 percent or more of total direct premiums earned for all coverages.

| State | Direct Premiums Earned (in thousands) | | Percent of Total | |
|---|---|---|---|---|
| California | $ | 147,585 | 18.7 | % |
| New York | 110,261 | | 14.0 | % |
| Florida | 109,146 | | 13.8 | % |
| Texas | 72,824 | | 9.2 | % |
| New Jersey | 32,486 | | 4.1 | % |
| Illinois | 24,107 | | 3.1 | % |
| Washington | 19,869 | | 2.5 | % |
| Pennsylvania | 18,658 | | 2.4 | % |
| Georgia | 15,673 | | 2.0 | % |
| Hawaii | 15,205 | | 1.9 | % |
| Massachusetts | 13,528 | | 1.7 | % |
| Michigan | 13,346 | | 1.7 | % |
| Arizona | 12,678 | | 1.6 | % |
| Tennessee | 12,154 | | 1.5 | % |
| Ohio | 11,934 | | 1.5 | % |
| All Other | 159,450 | | 20.3 | % |
| | | | | |
| Total direct premiums | $ | 788,904 | 100.0 | % |

In the ordinary course of business, we rely on other insurance companies to share risks through reinsurance. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk (known as facultative reinsurance). We have quota share, excess of loss and catastrophe reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. The arrangements allow us to pursue greater diversification of business and serve to limit the maximum net loss on catastrophes and large risks. Reinsurance is subject to certain risks, specifically market risk, which affects the cost of and the ability to secure these contracts, and collection risk, which is the risk that our reinsurers may not pay on losses in a timely fashion or at all. The following table illustrates, through premium volume, the degree to which we have utilized reinsurance during the past three years. For an expanded discussion of the impact of reinsurance on our operations, see Note 5 to our audited consolidated financial statements included in our 2006 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

| Premiums Written (in thousands) | Year Ended December 31, 2006 | | | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|---|---|---|
| Direct & Assumed | $ | 799,013 | | $ | 756,012 | | $ | 752,588 | |
| Reinsurance ceded | (247,477 | | ) | (261,447 | | ) | (241,376 | | ) |
| Net | $ | 551,536 | | $ | 494,565 | | $ | 511,212 | |

**Specialty Insurance Market Overview**

The specialty insurance market differs significantly from the standard market. In the standard market, insurance rates and forms are highly regulated, products and coverage are largely uniform with relatively predictable exposures, and companies tend to compete for customers on the basis of price. In contrast, the specialty market provides coverage for risks that do not fit the underwriting criteria of the standard carriers. Competition tends to focus less on price and more on availability, service and other value-based considerations. While specialty market exposures may have higher insurance risks than their standard market counterparts, we manage these risks to achieve higher financial returns. To reach our financial and operational goals, we must have extensive knowledge and expertise in our markets. Most of our risks are considered on an individual basis and restricted limits, deductibles, exclusions and surcharges are employed in order to respond to distinctive risk characteristics.

We operate in the excess and surplus insurance market and the specialty admitted insurance market.

***Excess and Surplus Insurance Market***

The excess and surplus market focuses on hard-to-place risks. Excess and surplus eligibility allows our insurance subsidiaries to underwrite nonstandard market risks with more flexible policy forms and unregulated premium rates. This typically results in coverages that are more restrictive and more expensive than in the standard admitted market. The excess and surplus lines regulatory environment and production model also effectively filters submission flow and matches market opportunities to our expertise and appetite. The excess and surplus market represented approximately $28 billion, or 6 percent, of the entire $489 billion domestic property and casualty industry, as measured by direct premiums written. For 2006, our excess and surplus operation wrote gross premiums of $449.1 million representing approximately 56 percent of our total gross premiums written for the period.

***Specialty Admitted Insurance Market***

We also write business in the specialty admitted market. Most of these risks are unique and hard to place in the standard market, but for marketing and regulatory reasons, they must remain with an admitted insurance company. The specialty admitted market is subject to greater state regulation than the excess and surplus market, particularly with regard to rate and form filing requirements, restrictions on the ability to exit lines of business, premium tax payments and membership in various state associations, such as state guaranty funds and assigned risk plans. For 2006, our specialty admitted operations wrote gross premiums of $349.9 million representing approximately 44 percent of our total gross premiums written for the year.

**Business Segment Overview**

Our segment data is derived using the guidance set forth in Statement of Financial Accounting Standards (SFAS) 131, Disclosures about Segments of an Enterprise and Related information. As prescribed by the pronouncement, reporting is based on the internal structure and reporting of information as it is used by management. The segments of our insurance operations include property, casualty, and surety. For additional information, see Note 11 to our audited consolidated financial statements included in our 2006 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

***Casualty Segment***

*General Liability*

Our general liability business consists primarily of coverage for third party liability of commercial insureds including manufacturers, contractors, apartments and mercantile. Net premiums earned from this business totaled $180.0 million, $180.3 million and $175.0 million, or 28 percent, 32 percent, and 30 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

*Commercial and Personal Umbrella Liability*

Our commercial umbrella coverage is principally written in excess of primary liability insurance provided by other carriers and, to a modest degree, in excess of primary liability written by us. The personal umbrella coverage is written in excess of the homeowners and automobile liability coverage provided by other carriers, except in Hawaii, where some underlying homeowners coverage is written by us. Net premiums earned from this business totaled $64.7 million, $59.8 million and $53.5 million, or 10 percent, 11 percent, and 9 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

*Executive Products*

We sell financial coverages, such as directors and officers (D&O) liability and other miscellaneous professional liability, for a variety of low to moderate classes of risks. Events affecting the economy over the past few years resulted in several insurers ceasing to write D&O coverage, which created an opportunity to raise rates significantly and reduce exposures. This situation rapidly changed in early 2004 with the return of price competition, particularly in the large account sector. As a consequence, we shifted our focus to smaller accounts. Our target accounts include publicly traded companies with market capitalization below $5 billion (where we are writing part of the traditional D&O program), Clause 1 (also known as Side A coverage) opportunities for investment-grade publicly traded companies, private companies, nonprofit organizations, and sole-sponsored and multi-employer fiduciary liability accounts. We are currently successfully transitioning from primarily writing high layers of excess D&O for publicly traded companies to writing more Clause 1 coverage. Additionally, we are having success rounding out our portfolio by writing more fiduciary liability coverage, primary and excess D&O coverage for private companies and non-profit organizations. Net premiums earned from this business totaled $13.0 million, $9.8 million, and $13.1 million, or 2 percent of consolidated revenues for 2006, 2005, and 2004.

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*Specialty Program Business*

We offer program business in a variety of areas. Our program coverages include: commercial property, general liability, inland marine, and crime. Often, these coverages are combined into a package or portfolio policy. We have recently moved to a strategy of bringing most risk underwriting in house while continuing to rely upon program administrators for policy servicing and sales. We continue to develop new programs for a variety of affinity groups. Net premiums earned from this business totaled $25.5 million, $38.3 million, and $47.1 million for 2006, 2005, and 2004, respectively. These amounts represent 4 percent, 7 percent, and 8 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

*Commercial Transportation*

Our transportation insurance facility in Atlanta provides automobile liability and physical damage insurance to local, intermediate and long haul truckers, public transportation risks and equipment dealers. In early 2005, we expanded our focus to include other types of commercial automobile risks. We also offer incidental, related insurance coverages, including general liability, commercial umbrella and excess liability, and motor truck cargo. The facility is staffed by highly experienced transportation underwriters who produce business through independent agents and brokers nationwide. Net premiums earned from this business totaled $48.3 million, $51.7 million, and $56.0 million, or 8 percent, 9 percent, and 10 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

*Other*

We offer a variety of other smaller programs in our casualty segment, including deductible buy-back, at-home business, and employer s excess indemnity. Net premiums earned from these lines totaled $16.6 million, $19.0 million, and $20.9 million, or 3 percent, 3 percent, and 4 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

***Property Segment***

*Commercial and Construction*

Our commercial property coverage consists primarily of excess and surplus lines and specialty insurance such as fire, earthquake and difference in conditions, which can include earthquake, wind, flood and collapse coverages, and inland marine. We provide insurance for a wide range of commercial and industrial risks, such as office buildings, apartments, condominiums, and certain industrial and mercantile structures. We also write boiler and machinery coverage under the same management as commercial property. Net premiums earned from commercial property business totaled $91.5 million, $66.4 million, and $69.2 million, or 14 percent, 11.5 percent, and 12 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

In late 2005, we began to exit the retail construction market, due to continued poor performance in this line. We have continued to wind down this coverage through 2006, which we expect to complete in 2007. In 2006, 2005, and 2004, construction net premiums earned totaled $4.5 million, $2.5 million, and $21.6 million, or 1 percent, 0.5 percent, and 4 percent, respectively, of consolidated revenues.

*Marine*

In 2005, we launched a new marine operation serving the marine business marketplace. The focus of this operation is on brown water ocean marine (near shore, river and Great Lakes) coverages including hull, cargo and P&I. This unit continues to meet expectations and has expanded its reach to a limited number of inland marine coverages including builder s risk and contractors equipment. In 2006 and 2005, marine net premiums earned totaled $16.8 million and $3.3 million, or 3 percent and 1 percent, respectively, of consolidated revenues.

*Other*

We offer a limited amount of homeowners and dwelling fire insurance in Hawaii. Recently, we have curtailed our wind exposure through a more restrictive policy, which limits wind coverage on new business. Net premiums earned from this business totaled $9.8 million, $8.3 million, and $7.2 million, or 2 percent, 1 percent, and 1 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

***Surety Segment***

Our surety segment specializes in providing coverage for individuals, contractors, small business owners, small to large

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corporations, and businesses operating in the energy, petrochemical and refining industries. We also offer miscellaneous and contract surety bonds, including fidelity and court sureties. These bonds are written through independent agencies as well as regional and national brokers. Net earned premium totaled $59.5 million, $51.9 million, and $47.7 million, or 9 percent, 9 percent and 8 percent of consolidated revenues for 2006, 2005, and 2004, respectively.

**Competition**

Our specialty property and casualty insurance subsidiaries are part of an extremely competitive industry that is cyclical and historically characterized by periods of high premium rates and shortages of underwriting capacity followed by periods of severe competition and excess underwriting capacity. Within the United States alone, approximately 2,400 companies, both stock and mutual, actively market property and casualty coverages. Our primary competitors in our casualty segment are, among others, AIG, St. Paul/Travelers, Scottsdale Insurance, Lexington Insurance Company, General Star, CNA, Chubb, and Great West Casualty Company. Our primary competitors in our property segment are, among others, Lexington Insurance Company, ARCH Insurance Company, General Star, Philadelphia Insurance, Markel, and St. Paul/Travelers. Our primary competitors in our surety segment are, among others, North American Specialty Insurance Co., CNA Surety, and St. Paul/Travelers. Many of these competitors have significantly more financial and other resources than RLI. The combination of coverages, service, pricing and other methods of competition vary from line to line. Our principal methods of meeting this competition are innovative coverages, marketing structure and quality service to the agents and policyholders at a fair price. We compete favorably in part because of our sound financial base and reputation, as well as our broad geographic penetration into all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. In the property and casualty area, we have acquired experienced underwriting specialists in our branch and home offices. We have continued to maintain our underwriting and marketing standards by not seeking market share at the expense of earnings. We have a track record of withdrawing from markets when conditions become overly adverse. We offer new coverages and new programs where the opportunity exists to provide needed insurance coverage with exceptional service on a profitable basis.

**Ratings**

A.M. Best ratings for the industry range from A++ (Superior) to F (In Liquidation) with some companies not being rated. Standard & Poor s ratings for the industry range from AAA (Superior) to R (Regulatory Action). Moody s ratings for the industry range from Aaa (Exceptional) to C (Lowest). The following table illustrates the range of ratings assigned by each of the three major rating companies that has issued a financial strength rating on our insurance companies:

| **A.M. Best** | | **Standard & Poor s** | | **Moody s** | |
|---|---|---|---|---|---|
| SECURE | | SECURE | | STRONG | |
| A++, A+ | Superior | AAA | Extremely strong | Aaa | Exceptional |
| A,A- | Excellent | AA | Very strong | Aa | Excellent |
| B++, B+ | Very good | A | Strong | A | Good |
| | | BBB | Good | Baa | Adequate |
| | | | | | |
| VULNERABLE | | VULNERABLE | | WEAK | |
| B,B- | Fair | BB | Marginal | Ba | Questionable |
| C++,C+ | Marginal | B | Weak | B | Poor |
| C,C- | Weak | CCC | Very weak | Caa | Very poor |
| D | Poor | CC | Extremely weak | Ca | Extremely poor |
| E | Under regulatory supervision | R | Regulatory action | C | Lowest |
| F | In liquidation | | | | |
| S | Rating suspended | | | | |
| | | | | | |
| Within-category modifiers | | +,- | | 1,2,3 (1 high, 3 low) | |

Publications of A.M. Best, Standard & Poor s and Moody s indicate that A and A+ ratings are assigned to those companies that, in their opinion, have achieved excellent overall performance when compared to the standards established by these firms and have a strong ability to meet their obligations to policyholders over a long period of time. In evaluating a company s financial and operating performance, each of the firms reviews the company s profitability, leverage and liquidity, as well as the company s spread of risk, the quality and appropriateness of its reinsurance, the quality and diversification of its assets, the adequacy of its policy and loss reserves, the adequacy of its surplus, its capital structure, its risk

management practices and the experience and objectives of its management. These ratings are based on factors relevant to policyholders, agents, insurance brokers and intermediaries and are not directed to the protection of investors.

At December 31, 2006, the following ratings were assigned to our insurance companies:

| | |
|---|---|
| **A.M. Best** | |
| RLI Insurance, Mt. Hawley Insurance, and RLI Indemnity (RLI Group) | A+, Superior |
| **Standard & Poor's** | |
| RLI Insurance and Mt. Hawley Insurance | A+, Strong |
| **Moody's** | |
| RLI Insurance, Mt. Hawley Insurance and RLI Indemnity | A2, Good |

For A.M Best, Standard & Poor s and Moody s, the financial strength ratings represented above are affirmations of previously assigned ratings. A.M. Best, in addition to assigning a financial strength rating, also assigns financial size categories. During 2006, RLI Insurance Company, Mt. Hawley Insurance Company and RLI Indemnity Company, collectively referred to as RLI Group, were assigned a financial size category of X (adjusted policyholders surplus of between $500 and $750 million). As of December 31, 2006, the policyholders surplus of RLI Group reached $746.9 million.

RLI Corp s existing $100 million of senior notes maturing in 2014 maintains a Standard & Poor s rating of BBB+ , Moody s Baa2 , and an A.M. Best rating of A-.

**Reinsurance**

We reinsure a significant portion of our property and casualty insurance exposure, paying or ceding to the reinsurer a portion of the premiums received on such policies. Earned premiums ceded to non-affiliated reinsurers totaled $265 million, $248 million and $242 million in 2006, 2005, and 2004, respectively. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. Although reinsurance does not legally discharge an insurer from its primary liability for the full amount of the policies, it does make the assuming reinsurer liable to the insurer to the extent of the insurance ceded.

We attempt to purchase reinsurance from a limited number of financially strong reinsurers. Retention levels are adjusted each year to maintain a balance between the growth in surplus and the cost of reinsurance. Each of the top 10 largest reinsurers (listed below and ranked based on amounts recoverable) are rated A- or better by A.M. Best and Standard and Poor s rating services. Additionally, over 94 percent of our reinsurance recoverables are due from companies rated A- or better by A.M. Best and Standard & Poor s rating services.

The following table sets forth the ten largest reinsurers in terms of amounts recoverable, net of collateral we are holding from such reinsurers, as of December 31, 2006. Also shown are the amounts of written premium ceded to these reinsurers during the calendar year 2006.

| **(dollars in thousands)** | **A.M. Best Rating** | **S & P Rating** | **Net Reinsurer Exposure as of 12/31/2006** | **Percent of Total** | | **Ceded Premiums Written** | **Percent of Total** | |
|---|---|---|---|---|---|---|---|---|
| Munich Re America | A | A- | $ 136,069 | 23.2 | % | $ 24,773 | 10.0 | % |
| General Rein Corp | A++ | AAA | 55,704 | 9.5 | % | 2,797 | 1.1 | % |
| Swiss Reinsurance | A+ | AA- | 44,693 | 7.6 | % | 12,565 | 5.1 | % |
| Berkley Insurance Company | A | A+ | 36,397 | 6.2 | % | 18,193 | 7.4 | % |
| Lloyds of London | A | A | 32,525 | 5.6 | % | 20,262 | 8.2 | % |
| Endurance Reinsurance Corp. | A- | A | 30,275 | 5.2 | % | 19,398 | 7.8 | % |
| Toa-Re | A | A+ | 30,014 | 5.1 | % | 13,288 | 5.4 | % |
| Employers Reinsurance Corp. | A+ | AA- | 25,473 | 4.3 | % | 1,639 | 0.7 | % |
| Everest Reinsurance | A+ | AA- | 24,870 | 4.2 | % | 16,379 | 6.6 | % |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Liberty Mutual Insurance | A | A | | 20,780 | 3.5 | % | 1,278 | 0.5 | % |
| All other reinsurers | | | | 149,573 | 25.6 | % | 116,905 | 47.2 | % |
| Total ceded exposure | | | $ | 586,373 | 100.0 | % $ | 247,477 | 100.0 | % |

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Reinsurance is subject to certain risks, specifically market risk (which affects the cost of and the ability to secure reinsurance contracts) and collection risk (which relates to the ability to collect from the reinsurer on our claims). Much of our reinsurance is purchased on an excess of loss basis. Under an excess of loss arrangement, we retain losses on a risk up to a specified amount and the reinsurers assume any losses above that amount. It is common to find conditions in excess of loss covers such as occurrence limits, aggregate limits and reinstatement premium charges.

We analyze our reinsurance covers in conjunction with our three segments: property, casualty and surety.

In the property segment, the reinsurance structure is divided into three categories: commercial property, catastrophe earthquake and catastrophe other than earthquake which could include such events as hurricanes, windstorm, hailstorms, explosions, severe winter weather, fires, etc.

*Commercial Property Reinsurance*

We utilize both treaty and facultative coverage for our property risks. Treaty coverage refers to a reinsurance contract that is applied to a group or class of business where all the risks written meet the criteria for that class. Facultative coverage is applied to individual risks as opposed to a group or class of business. It is used for a variety of reasons including supplementing the limits provided by the treaty coverage or covering risks or perils excluded from treaty reinsurance.

In 2007, for most risks, we retain the first $1.0 million in losses. Reinsurance covers the following:

- 85% of the next $4.0 million in losses (we retain 15% of that $4.0 million); and
- 100% of the next $5.0 million in losses bringing our total retention to $1.6 million.

In 2006, for most risks, we retained the first $1.0 million in losses. Reinsurance then covered the following:

- 75% of the next $4.0 million in losses (we retained 25% of that $4.0 million); and
- 100% of the next $5.0 million in losses bringing our total retention to $2.0 million

In 2005, for most risks, we retained the first $0.5 million in losses. Reinsurance then covered the following:

- 100% of the next $0.5 million in losses;
- 85% of the next $4.0 million in losses (we retained 15% of that $4.0 million); and
- 100% of the next $5.0 million in losses bringing our total retention to $1.1 million.

*Property Reinsurance- Catastrophe (CAT) Coverage*

Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our property segment. Catastrophes involve multiple claims and policyholders. Over the three years presented, CAT premium costs increased as additional limits were purchased. For 2007, we purchased an additional $50.0 million in limit, bringing our total limit up to $500.0 million from $450.0 million. Our cost for catastrophe reinsurance for 2007 increased approximately 26% over 2006. We also purchased an additional $50.0 million in catastrophe reinsurance in 2006, bringing our total limits in 2006 to $450.0 million. In 2005, an additional $25.0 million in limit was added, bringing the total limit to $400.0 million for that year. These CAT limits are in addition to the per-occurrence coverage provided by facultative and treaty coverages.

Our property catastrophe program continues to be on an excess of loss basis. It attaches after all other reinsurance has been considered. Although covered in one program, limits and attachment points differ for California earthquakes and all other perils. The following charts use information from our catastrophe modeling software to illustrate our net retention resulting from particular events that would generate the listed levels of gross losses:

**Catastrophe - California Earthquake**

**(in thousands)**

| Projected Gross Loss | 2007 Ceded Losses | Net Losses | 2006 Ceded Losses | Net Losses | 2005 Ceded Losses | Net Losses |
|---|---|---|---|---|---|---|
| $50,000 | $ 6,000 | $ 44,000 | $ 6,000 | $ 44,000 | $ 30,000 | $ 20,000 |
| 100,000 | 53,000 | 47,000 | 53,000 | 47,000 | 68,000 | 32,000 |
| 250,000 | 187,000 | 63,000 | 176,000 | 74,000 | 202,000 | 48,000 |
| 500,000 | 417,000 | 83,000 | 385,000 | 115,000 | 390,000 | 110,000 |

**Catastrophe - Wind**

**(in thousands)**

| Projected Gross Loss | 2007 Ceded Losses | Net Losses | 2006 Ceded Losses | Net Losses | 2005 Ceded Losses | Net Losses |
|---|---|---|---|---|---|---|
| $10,000 | $ 2,000 | $ 8,000 | $ 2,000 | $ 8,000 | $ 2,000 | $ 8,000 |
| 50,000 | 29,000 | 21,000 | 41,000 | 9,000 | 40,000 | 10,000 |
| 100,000 | 75,000 | 25,000 | 82,000 | 18,000 | 80,000 | 20,000 |
| 250,000 | 206,000 | 44,000 | 206,000 | 44,000 | 206,000 | 44,000 |

These tables were generated using theoretical probabilities of events occurring in areas where our portfolio of currently in-force policies could generate the level of loss shown. Actual results could vary significantly from these tables as the actual nature or severity of a particular event cannot be predicted with any reasonable degree of accuracy.

Our catastrophe program includes one prepaid reinstatement for the first two layers of coverage for a catastrophe other than California earthquake. A reinstatement must be purchased for the remaining limits. For a California earthquake, there is a prepaid reinstatement for the $50.0 million excess $50.0 million layer (placed at 92%) and a reinstatement must be purchased for the remaining limits.

*Casualty Reinsurance*

Our 2007 casualty reinsurance includes both excess of loss treaties and quota share treaties, as was the case in 2006, and 2005. With respect to our 2007 Combined Casualty Treaty, we retain between $0.9 million and $2.0 million of the full losses, depending on type of policy or risk. This was also the case in 2006. In 2005, we retained between $0.6 and $1.8 million of the full losses. For our Executive Products Group (EPG) coverage, our maximum retained loss on a policy in 2007 will not exceed $4.0 million. In 2006 and 2005, our maximum retained loss on any EPG policy was $3.0 million. Over the three years presented, casualty reinsurance rates have been fairly stable.

*Surety Reinsurance*

Our surety reinsurance treaty is on an excess of loss basis for 2007, as it was in 2006 and 2005. Under the current treaty, we retain the first $1.0 million in loss (as was the case in 2006 and 2005). Reinsurance covers the following:

- 100% of the next $4.0 million in losses;
- 90% of the next $10.0 million in losses, we retain 10%; and
- 50% of the next $10.0 million in losses, we retain 50%.

Our maximum net loss for any one principal will not exceed $7.0 million. For most risks, our net loss does not exceed $2.0 million.

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*Catastrophe Management*

We continuously monitor and quantify our exposure to catastrophes, including earthquakes, hurricanes, terrorist acts, and other catastrophic events. In the normal course of business, we manage our concentrations of exposures to catastrophic events, primarily by limiting concentrations of exposure to acceptable levels, and by purchasing reinsurance. We use third party catastrophe exposure models and internally developed analysis to assess each risk and ensure we include an appropriate charge for assumed catastrophe risks. For the application of the catastrophe exposure models, exposure and coverage detail is recorded for each risk location. Catastrophe exposure modeling is inherently uncertain due to the model s reliance on a large number of data points, increasing the importance of capturing accurate policy coverage data. The model results are used both in the underwriting analysis of individual risks, and at a corporate level for the aggregate book of catastrophe-exposed business. From both perspectives, we consider the potential loss produced by individual events that represent moderate-to-high loss potential at varying return periods and magnitudes. In calculating potential losses, we select appropriate assumptions, including but not limited to loss amplification and storm surge. We establish risk tolerances at the portfolio level based on market conditions, the level of reinsurance available, changes to the assumptions in the catastrophe models, rating agency constraints, underwriting guidelines and coverages, and internal preferences. Our risk tolerances for each type of catastrophe, and for all perils in aggregate, change over time as these internal and external conditions change.

**Marketing and Distribution**

We distribute our coverages primarily through branch offices throughout the country that market to wholesale and retail brokers and through independent agents. We also market through agencies and more recently through e-commerce channels.

***Broker Business***

The largest volume of broker-generated premium is in our commercial property, general liability, commercial surety, commercial umbrella and commercial automobile coverages. This business is produced through wholesale and retail brokers who are not affiliated with us.

***Independent Agent Business***

Our surety segment offers its business through a variety of independent agents. Additionally, we write program business, such as at-home business and personal umbrella, through independent agents. Homeowners and dwelling fire is produced through independent agents in Hawaii. Each of these programs involves detailed eligibility criteria, which are incorporated into strict underwriting guidelines, and prequalification of each risk using a system accessible by the independent agent. The independent agent cannot bind the risk unless they receive approval through our system.

***Underwriting Agents***

We contract with certain underwriting agencies who have limited authority to bind or underwrite business on our behalf. These agencies may receive some compensation through contingent profit commission.

***E-commerce***

We are actively employing e-commerce to produce and efficiently process and service business, including package policies for limited service motel/hotel operations, restaurant/bar/tavern operations and at-home businesses, small commercial and personal umbrella risks, earthquake property coverage and surety bonding.

**Environmental, Asbestos, and Mass Tort Exposures**

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

The following table represents inception-to-date paid and unpaid environmental claims data (including incurred but not reported losses) for the periods ended 2006, 2005, and 2004:

| **(dollars in thousands)** | **Inception-to-date at December 31, 2006** | **2005** | **2004** |
|---|---|---|---|
| Loss and Loss Adjustment Expense (LAE) payments | | | |
| Gross | $ 53,323 | $ 46,685 | $ 44,360 |
| Ceded | (29,853) | (26,888) | (25,590) |
| Net | $ 23,470 | $ 19,797 | $ 18,770 |
| Unpaid losses and LAE at end of year | | | |
| Gross | $ 48,541 | $ 47,391 | $ 43,716 |
| Ceded | (25,720) | (30,950) | (28,998) |
| Net | $ 22,821 | $ 16,441 | $ 14,718 |

Our environmental, asbestos, and mass tort exposure is limited, relative to that of other insurers, as a result of entering the affected liability lines after the insurance industry had already recognized environmental and asbestos exposure as a problem and adopted appropriate coverage exclusions. During 2006, we reviewed our reserves for these exposures relative to industry benchmarks and re-evaluated its emergence patterns. As a result, net reserves for these exposures were increased $6.4 million. Other significant activity during 2006 was payment for the settlement of a large claim associated with a Superfund site. The claim arose out of commercial umbrella business written in the early 1980s. Gross payments of $4.0 million and net payments of $2.1 million for this claim caused the majority of the 2006 increase, reflected in the table above. This claim had no effect on 2006 incurred losses, however, because an adequate case reserve estimate had been established for it in 2004.

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

**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.

Loss and loss adjustment reserves by product line at year-end 2006 and 2005 were as follows:

| **(as of December 31, in $millions)** | **2006** | | | **2005** | | |
|---|---|---|---|---|---|---|
| **Product Line** | **Case** | **IBNR** | **Total** | **Case** | **IBNR** | **Total** |
| *Casualty segment loss and ALAE reserves* | | | | | | |
| Commercial umbrella | $ 12,513 | $ 49,667 | $ 62,180 | $ 15,038 | $ 41,730 | $ 56,768 |
| Personal umbrella | 20,771 | 34,010 | 54,781 | 16,159 | 30,759 | 46,918 |
| General liability | 78,290 | 251,287 | 329,577 | 69,612 | 220,645 | 290,257 |
| Transportation | 60,725 | 21,911 | 82,636 | 59,260 | 20,448 | 79,708 |
| Executive products | 5,645 | 27,229 | 32,874 | 8,495 | 27,382 | 35,877 |
| Other casualty | 25,075 | 57,676 | 82,751 | 31,952 | 65,698 | 97,650 |
| *Property segment loss and ALAE reserves* | | | | | | |
| Difference in conditions | 648 | 6,250 | 6,898 | 1,057 | 6,240 | 7,297 |
| Marine | 4,942 | 4,374 | 9,316 | 987 | | |