RLI CORP
Form 10-K
February 25, 2009

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, 2008

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 (State or other jurisdiction of incorporation or organization)	**37-0889946** (I.R.S. Employer Identification No.)
9025 North Lindbergh Drive, Peoria, Illinois (Address of principal executive offices)	**61615** (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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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, 2008, based upon the closing sale price of the Common Stock on June 30, 2008 as reported on the New York Stock Exchange, was $876,307,820. 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 13, 2009 was 21,494,311.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the 2008 Financial Report to Shareholders for the past year ended December 31, 2008, are incorporated by reference into Parts I and II of this document.

Portions of the Registrant s definitive Proxy Statement for the 2009 annual meeting of security holders to be held May 7, 2009, are incorporated herein by reference into Part III of this document.

Exhibit index is located on pages 57-58 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 or furnished.

As a niche company, we offer specialty insurance coverages designed to meet specific insurance needs of targeted insured groups and underwrite particular types of coverage for certain markets that are underserved by the insurance industry, such as our difference in conditions coverages or oil and gas surety bonds. We also provide types of coverages not generally offered by other companies, such as our stand-alone personal umbrella policy. The excess and surplus market, which unlike the standard admitted market is less regulated and more flexible in terms of policy forms and premium rates, provides an alternative 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 throughout the United States.

For the year ended December 31, 2008, 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, 2008, no other state 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	$	130,780	18.8%
New York		106,108	15.2%
Florida		88,000	12.6%
Texas		55,888	8.0%
New Jersey		25,787	3.7%
Illinois		19,272	2.8%
Washington		18,413	2.6%
Pennsylvania		16,970	2.4%
Hawaii		16,544	2.4%
Louisiana		14,851	2.1%
Massachusetts		11,257	1.6%
Michigan		10,867	1.6%
Ohio		10,465	1.5%
Arizona		10,402	1.5%
All Other		160,219	23.2%
Total direct premiums	$	695,823	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 credit 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 2008 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

Premiums Written (in thousands)		Year Ended December 31, 2008		2007		2006
Direct & Assumed	$	681,169	$	739,334	$	799,013
Reinsurance ceded		(167,713)		(200,571)		(247,477)
Net	$	513,456	$	538,763	$	551,536

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 us 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. In 2008, the excess and surplus market represented approximately $27 billion, or 5 percent, of the entire $504 billion domestic property and casualty industry, as measured by direct premiums written. Our excess and surplus operation wrote gross premiums of $321.6 million, or 47 percent, of our total gross premiums written.

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 2008, our specialty admitted operations wrote gross premiums of $359.6 million representing approximately 53 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 are casualty, property and surety. For additional information, see Note 11 to our audited consolidated financial statements included in our 2008 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 $140.9 million, $167.9 million and $180.0 million, or 25 percent, 26 percent, and 28 percent of consolidated revenues for 2008, 2007, and 2006, 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 $65.1 million, $66.3 million and $64.7 million, or 12 percent, 10 percent, and 10 percent of consolidated revenues for 2008, 2007, and 2006, 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 $46.7 million, $49.1 million, and $48.3 million, or 8 percent of consolidated revenues for 2008, 2007, and 2006.

Executive Products

We provide a variety of professional liability coverages, such as directors and officers (D&O) liability insurance, employment practices liability and other miscellaneous professional liability coverages, for a variety of low to moderate classes of risks. We tend to focus on smaller accounts, avoiding the large account sector which is generally more sensitive to price competition. 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, which is direct liability coverage for the individual directors and officers), private companies, nonprofit organizations, and sole-sponsored and multi-employer fiduciary liability accounts. We successfully transitioned 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 $13.8 million, $12.0 million, and $13.0 million, or 2 percent of consolidated revenues for 2008, 2007, and 2006.

Specialty Program Business

We offer program business in a variety of areas, which are typically multiple coverages combined into a package or portfolio policy. Our program coverages include: commercial property, general liability, inland marine, and crime. We rely primarily on program administrators as sources for this business. Net premiums earned from this business totaled $31.4 million, $29.4 million, and $25.5 million for 2008, 2007, and 2006, respectively. These amounts represent 6 percent, 5 percent, and 4 percent of consolidated revenues for 2008, 2007, and 2006, 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 $15.5 million, $18.7 million, and $16.6 million, or 3 percent of consolidated revenues for 2008, 2007, and 2006.

Property Segment

Commercial

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 $85.3 million, $92.6 million, and $91.5 million, or 15 percent, 14 percent, and 14 percent of consolidated revenues for 2008, 2007, and 2006, respectively.

Marine

In 2005, we launched a new marine insurance division. Marine coverages include hull, cargo and protection and indemnity (P&I), as well as inland marine coverages including builders risks, contractors equipment and other floater type coverages. In May 2007, the marine division added specialty cargo coverage that focuses on high-tech and life sciences risks. In March 2008, the marine division added a yacht program. In 2008, 2007 and 2006, marine net premiums earned totaled $48.2 million, $32.9 million and $16.8 million, or 9 percent, 5 percent and 3 percent, respectively, of consolidated revenues.

Other

We offer a variety of other smaller programs in our property segment, including a limited amount of homeowners and dwelling fire insurance in Hawaii. We have reduced our Hawaii wind exposure through more restrictive underwriting over the last 18 months.

In July 2007, we launched a new division focusing on facultative reinsurance. The division is responsible for underwriting property facultative reinsurance for insurance companies utilizing reinsurance intermediaries.

Net premiums earned from the above coverages totaled $13.4 million, $12.9 million, and $14.3 million, or 2 percent of consolidated revenues for 2008, 2007, and 2006.

Surety Segment

Our surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. We offer miscellaneous bonds, including license and permit, notary, and court bonds. In September 2008, we launched a new Fidelity Division focusing on fidelity and crime coverage for commercial insureds and select financial institutions. These bonds are written through independent agencies as well as regional and national brokers. Net earned premium totaled $68.4 million, $62.7 million, and $59.5 million, or 12 percent, 10 percent and 9 percent of consolidated revenues for 2008, 2007, and 2006, 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, Ace, Arch, James River, Landmark, Navigators, USLI, Great West, Lancer, National Interstate, Chubb, Philadelphia, Great American, Travelers and CNA. Our primary competitors in our property segment are, among others, Ace, Lexington, Arch, Crum & Forster, Travelers and Markel. Our primary competitors in our surety segment are, among others, Ace, Arch, HCC, CNA, Safeco, North American Specialty, Travelers and Hartford. 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 (Extremely strong) 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 opini 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, 2008, 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 2008, 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, 2008, the policyholders statutory surplus of RLI Group totaled $678.0 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 a Fitch rating of BBB.

Reinsurance

We reinsure a 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 $172.3 million, $227.1 million, and $264.5 million in 2008, 2007, and 2006, respectively. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. While reinsurance does not relieve us of our legal liability to our policyholders, we use reinsurance as an alternative to using our own capital to fund losses. Retention levels are adjusted each year to maintain a balance between the growth in surplus and the cost of reinsurance. 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.

Reinsurance is subject to certain risks, specifically market risk (which affects the cost of and the ability to secure reinsurance contracts) and credit risk (which relates to the ability to collect from the reinsurer on our claims). We purchase reinsurance from a number of financially strong reinsurers. We evaluate reinsurers ability to pay based on their financial results, level of surplus, financial strength ratings, and other risk characteristics. A reinsurance committee, comprised of senior management, approves our security guidelines and reinsurer usage. 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, more than 91 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, 2008. Also shown are the amounts of written premium ceded to these reinsurers during the calendar year 2008.

(dollars in thousands)	A.M. Best Rating	S & P Rating		Net Reinsurer Exposure as of 12/31/2008	Percent of Total		Ceded Premiums Written	Percent of Total
Munich Re America	A+	AA-	$	59,716	15.9%	$	23,909	14.3%
Swiss Re / Westport Ins. Corp.	A+	A+		41,660	11.1%		8,125	4.8%
Endurance Re	A	A		40,632	10.8%		14,750	8.8%
Axis Re	A	A		32,743	8.7%		14,931	8.9%
General Cologne Re	A++	AAA		31,839	8.4%		2,053	1.2%
Berkley Insurance Co.	A+	A+		28,202	7.5%		6,081	3.6%
Toa-Re	A	A+		17,916	4.7%		5,476	3.3%
Lloyds of London	A	A+		15,184	4.0%		16,319	9.7%
Ace Property & Casualty	A+	A+		15,078	4.0%		5,702	3.4%
Transatlantic Re	A	AA-		14,892	4.0%		8,558	5.1%
All other reinsurers				78,513	20.9%		61,809	36.9%
Total ceded exposure			$	376,375	100.0%	$	167,713	100.0%

We utilize both treaty and facultative reinsurance coverage for our 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.

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. We may choose to participate in the reinsurance layers purchased by retaining a percentage of the layer. It is common to find conditions in excess of loss covers such as occurrence limits, aggregate limits and reinstatement premium charges. Occurrence limits cap our recovery for multiple losses caused by the same event. Aggregate limits cap our recovery for all losses ceded during the contract term. We may be required to pay additional premium to reinstate or have access to use the reinsurance limits for potential future recoveries during the same contract year. Our property and surety treaties tend to include reinstatement provisions.

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

Our commercial property treaty renews annually on January 1. In 2009, 2008, 2007, and 2006, for most risks, we retain the first $1.0 million in losses. We purchase treaty reinsurance for the next $9.0 million in limit. We retain $600,000 within the treaty. In 2006, we retained $1.0 million within the treaty.

The marine treaty renews May 1 annually. For marine exposures, we retain the first $1.0 million in losses. Reinsurance covers 100 percent of the next $39.0 million. For the 2007 treaty, we retained the first $1.0 million in losses and purchased coverage for 100 percent of the next $29.0

million. For the 2006 treaty, we retained the first $0.5 million in losses. We purchased $19.5 million of reinsurance and retained $0.4 million within the treaty structure.

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. Reinsurance limits purchased fluctuate due to changes in the number of policies we insure, reinsurance costs, insurance company surplus levels, and our risk appetite. In addition, we monitor the expected rate of return for each of our catastrophe lines of business. At high rates of return, we grow the book of business and may purchase additional reinsurance depending on our capital position. As the rate of return decreases, we shrink the book and may purchase less reinsurance. For the last three years, we have maintained a $25.0 million first dollar retention. For 2009, we purchased $350.0 million in limit above our retention. We purchased $375.0 million in limit in 2008 which decreased to $350.0 million at July 1, 2008. In 2007, we purchased $475.0 million in catastrophe reinsurance which decreased to $425.0 million at July 1, 2007. These CAT limits are in addition to the per-occurrence coverage provided by facultative and other treaty coverages. We have participated in the catastrophe layers purchased by retaining a percentage of each layer throughout this period. Our participation has varied based on price and the amount of risk transferred by each layer.

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 millions)

	2008		2007		2006	
Projected Gross Loss	**Ceded Losses**	**Net Losses**	**Ceded Losses**	**Net Losses**	**Ceded Losses**	**Net Losses**
$ 50	$ 7	$ 43	$ 6	$ 44	$ 21	$ 29
100	50	50	52	48	51	49
200	139	61	139	61	135	65
400	321	79	320	80	299	101

Catastrophe - Other (Earthquake outside of California, Wind, etc.)
(in millions)

	2008		2007		2006	
Projected Gross Loss	**Ceded Losses**	**Net Losses**	**Ceded Losses**	**Net Losses**	**Ceded Losses**	**Net Losses**
$ 25	$ 6	$ 19	$ 6	$ 19	$ 18	$ 7
50	29	21	29	21	41	9
100	73	27	76	24	84	16
200	162	38	163	37	168	32

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. Reinsurance limits are purchased based on the anticipated losses to large events. The largest losses shown above are unlikely to occur based on the probability of those events occurring. However, there is a remote chance that a larger event could occur. If the actual event losses are larger than anticipated, we could retain additional losses above the limit of our catastrophe reinsurance.

Our catastrophe program includes one prepaid reinstatement for the first two layers of coverage, up to $100 million, for a catastrophe other than California earthquake. If a loss does occur, 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 77 percent) and a reinstatement must be purchased for the remaining limits.

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. Exposure and coverage detail is recorded for each risk location. We quantify and monitor the total policy limit insured in each region. In addition, we use third party catastrophe exposure models and an internally developed analysis to assess each risk and ensure we include an appropriate charge for assumed catastrophe risks. Catastrophe exposure modeling is inherently uncertain due to the model s reliance on an infrequent observation of actual events and exposure data, 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 capital 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.

Casualty Reinsurance

Our 2009 casualty reinsurance includes both excess of loss treaties and quota share treaties, as was the case in 2008, and 2007. Annually on January 1, we place a Combined Casualty Treaty that incorporates coverage for a majority of our casualty lines. In 2009, we added transportation to the treaty effective May 1, 2009. Our first dollar retention on those lines of business covered ranges from $0.5 million to $1.0 million. Considering our participation in the reinsurance layers placed, our retention on a full limits loss ranges from $0.5 million to $1.5 million. Maximum reinsurance limits purchased are $10.0 million inclusive of our retention for the last three years. With respect to our 2008 Combined Casualty Treaty, we retained the initial $0.5 million to $1.0 million in loss. Our total retention considering participation in the reinsurance layers purchased ranged from $1.3 million to $1.4 million depending on the type of policy. This was also the case in 2007. For our transportation coverage, the separate treaty renews on May 1 annually. In 2008, we retained the first $0.5 million in loss. We purchased between $1.5 million and $4.5 million of reinsurance limit depending on the type of risk for the last three years. Our total retention inclusive of treaty participation ranged from $0.6 million and $1.0 million. We also retained the first $0.5 million in loss in our 2007 treaty. Our total retention inclusive of treaty participation ranged from $0.6 million and $0.9 million. For the 2006 treaty, our first dollar retention was $0.5 million and we placed 100 percent of the reinsurance limits purchased.

Our executive products group (EPG) treaty renews on July 1 annually. We have purchased quota share treaties over the last three years and have varied our percentage of participation. In 2008, our reinsurance limit increased to $25.0 million. Our maximum retained loss on a policy does not exceed $7.5 million. In 2007 and 2006, we purchased reinsurance limits up to $20.0 million. In 2007 and 2006, our maximum retained loss on any EPG policy was $6.0 million and $4.0 million, respectively.

Surety Reinsurance

Our surety reinsurance treaty renews on April 1 annually. The treaty is on an excess of loss basis. In 2008, we purchased reinsurance limits of $49.0 million above our $1.0 million first dollar retention. Within the reinsurance treaty, we participate up to a maximum retention of $6.3 million for any one principal. We purchased $34.0 million of reinsurance limit in 2007 above our first dollar retention of $1.0 million. Our maximum retention considering treaty participation was $8.0 million. In 2006, we purchased $24.0 million in limit with a $7.0 million maximum retention inclusive our first dollar retention of $1.0 million. For a majority of risks, our potential net loss did not exceed $2.0 million.

During 2008, we purchased a separate quota share treaty for our new fidelity product line. We retain up to $3.8 million in losses with a limit of $25.0 million. This treaty has a renewal date of March 1, 2010.

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. The underwriting agreements involve strict underwriting guidelines and the agents are subject to audits upon request. 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 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 casualty 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, asbestos, and mass tort claims data (including incurred but not reported losses) as of December 31, 2008, 2007, and 2006:

			Inception-to-date at December 31,			
(dollars in thousands)		**2008**		**2007**		**2006**
Loss and Loss Adjustment Expense (LAE) payments						
Gross	$	70,210	$	56,060	$	53,323
Ceded		(39,143)		(30,607)		(29,853)
Net	$	31,067	$	25,453	$	23,470
Unpaid losses and LAE at end of year						
Gross	$	65,583	$	67,891	$	48,541
Ceded		(20,407)		(29,198)		(25,720)
Net	$	45,176	$	38,693	$	22,821

Our environmental, asbestos and mass tort exposure is limited, relative to 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 2008, payment activity was more than we experienced in 2007, which was not surprising given the increased amount of case reserve activity during 2007. However, we did not observe a corresponding decrease in case reserves, as gross case reserves decreased by only $4.8 million while net case reserves increased by about $0.5 million. Much of the reported adverse development can be tied to a small number of claims. Two related asbestos claims from our assumed reinsurance book accounted for $2.7 million in gross emergence and $2.1 million in net emergence with large payments being made. A mass tort claim from accident year 2005 against an insured hotel involving carbon monoxide discharge accounted for another $1.6 million direct and $1.0 million net. In light of these developments and a few additional reported claims, we decided to strengthen our incurred but not reported (IBNR) position.

During 2007, while payment activity was less than we experienced in 2006, we experienced an unusual amount of case reserve activity. About two-thirds of the increase in net reserves was from case reserve adjustments. A $4.8 million case reserve increase was posted due to a reversal of a previous court decision for a claim involving pollution during the late 1980s. In addition, an insurance company we reinsured in the early 1980s and that went into liquidation in 1986, reported a number of claims in 2007. The largest of these involves asbestos. Because of this situation, we posted total net case reserves of $2.9 million. Also, a $2.2 million reserve adjustment was made on a 1983 asbestos related claim because the coverage layers below our excess policy had been exhausted. In addition to these case reserve increases, we made a minor adjustment in our emergence pattern assumptions that resulted in an increase in our total reserve position relative to industry benchmarks.

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

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

Due to inherent uncertainty underlying loss reserve estimates, including but not limited to the future settlement environment, final resolution of the estimated liability may be different from that anticipated at the reporting date. Therefore, actual paid losses in the future may yield a materially different amount than currently reserved favorable 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 LAE reserves case-specific reserves and IBNR reserves.

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

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

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

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

All decisions regarding our best estimate of ultimate loss and LAE reserves are made by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at December 31, 2008, make a reasonable provision to meet our future obligations.

Net loss and loss adjustment reserves by product line at year-end 2008 and 2007 were as follows:

	2008			2007		
(as of December 31, in $ thousands) **Product Line**	**Case**	**IBNR**	**Total**	**Case**	**IBNR**	**Total**
Casualty segment net loss and ALAE reserves						