

Letter To The Shareholders

Operating a business, like living itself, is fraught with risks. Insurance is a business which deals with risks daily and uses elaborate mathematical techniques to measure them. But the nature of risk is uncertainty of outcome, and, occasionally, events will undermine the best of calculations and precautions. That happened to us last year to a degree that was unprecedented...

This was written 33 years ago in Old Republic's 1975 annual report and referred to its first, most significant loss in the 50 years then ended. The financial statements for 2008 reflect our first annual loss since then.

Why We Posted a Loss

2008's negative results of \$558.3 million consisted of a net operating loss of \$188.1 million from the Company's basic insurance business, and an additional income statement charge of \$370.2 million. Most of the latter amount was related to paper losses on certain investment portfolio securities. This arose from so-called mark-to-market adjustments to the carrying value of securities—even though the Company has the staying power and expressed intent to hold them for a long period of time to at least recover their cost. The following table shows the sources of Old Republic's net income from actual transactions consummated by our business, together with the paper losses from mark-to-market bookkeeping adjustments.

Years ended December 31:	(\$ in Millions)				
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Operating revenues:					
General insurance	\$ 2,255.9	\$ 2,438.0	\$ 2,138.7	\$ 2,017.6	\$ 1,822.5
Mortgage guaranty	690.0	608.3	529.9	516.0	489.9
Title insurance	681.3	878.5	1,007.3	1,108.6	1,051.8
Corporate and other	96.8	95.6	99.2	98.6	79.3
Total	<u>\$ 3,724.2</u>	<u>\$ 4,020.6</u>	<u>\$ 3,775.2</u>	<u>\$ 3,741.0</u>	<u>\$ 3,443.7</u>
Pretax operating income (loss):					
General insurance	\$ 294.3	\$ 418.0	\$ 401.6	\$ 350.0	\$ 333.0
Mortgage guaranty	(594.3)	(110.4)	228.4	243.7	224.5
Title insurance	(46.3)	(14.7)	31.0	88.7	62.5
Corporate and other	13.5	15.1	-	(.1)	(17.2)
Sub-total	<u>(332.7)</u>	<u>308.0</u>	<u>661.1</u>	<u>682.4</u>	<u>602.9</u>
Income taxes (credits) on operations	<u>(144.6)</u>	<u>81.3</u>	<u>208.6</u>	<u>173.2</u>	<u>198.8</u>
Net operating income (loss)	<u>(188.1)</u>	<u>226.7</u>	<u>452.4</u>	<u>509.1</u>	<u>404.1</u>
Realized investment gains (losses) from actual transactions, net of taxes (credits)	<u>(2.7)</u>	<u>45.7</u>	<u>12.3</u>	<u>48.2</u>	<u>34.3</u>
Net income (loss) from consummated transactions	<u>(190.8)</u>	<u>272.4</u>	<u>464.8</u>	<u>557.4</u>	<u>438.4</u>
Investment losses from mark-to-market bookkeeping adjustments, net of deferred tax credits	<u>(367.5)</u>	<u>-</u>	<u>-</u>	<u>(6.0)</u>	<u>(3.3)</u>
Reported net income (loss)	<u>\$ (558.3)</u>	<u>\$ 272.4</u>	<u>\$ 464.8</u>	<u>\$ 551.4</u>	<u>\$ 435.0</u>
Net income (loss) per share:					
Net operating income (loss)	\$ (0.81)	\$ 0.97	\$ 1.94	\$ 2.19	\$ 1.75
Actual realized investment gains (losses)	<u>(0.01)</u>	<u>0.20</u>	<u>0.05</u>	<u>0.21</u>	<u>0.15</u>
Sub-total	<u>(0.82)</u>	<u>1.17</u>	<u>1.99</u>	<u>2.40</u>	<u>1.90</u>
Mark-to-market losses	<u>(1.59)</u>	<u>-</u>	<u>-</u>	<u>(0.03)</u>	<u>(0.01)</u>
Total	<u>\$ (2.41)</u>	<u>\$ 1.17</u>	<u>\$ 1.99</u>	<u>\$ 2.37</u>	<u>\$ 1.89</u>

As the table shows, Old Republic's operating earnings have declined significantly during the last three years. Most of this resulted from the Company's mortgage guaranty line, from its title insurance segment to a much lesser extent and, in 2008, from the general insurance group's consumer credit indemnity coverage. Underwriting results for all of these insurance coverages have been most affected by the past two years' dislocations in the housing and financial sectors of the American economy.

2008 Economic Backdrop and Issues

Last year's business landscape was marked by extraordinary economic events that shook financial markets and most institutional participants in them. These events can fairly be traced to government easy money and social engineering policies stretching back a dozen years or more, to many years of poor lending practices for consumer borrowings, and to a large swatch of the private sector whose mindset remained focused on short-term results. In our view, many of the difficulties have been exacerbated by poorly chosen or executed accounting and financial management practices.

- Certainly the use of **off-balance sheet transactional entities** such as structured investment vehicles (SIV), which hide the potential catastrophic loss exposures and true balance sheet leverage of many financial institutions, are examples of accounting legerdemain.
- The distribution and market acceptance of many **unregulated, untested, and opaque financial instruments**—such as collateralized debt obligations (CDOs), credit default swaps (CDS), and residual mortgage-backed securities (RMBS)—have grown exponentially in recent years. Many of these securities have lacked much—if any—capital underpinnings, have not had a liquid market for trading, have had economic values that were difficult to audit and verify and, in many instances, have been mere IOUs unsupported by real money commitments by the promisors.
- The **obsession with mark-to-market accounting pronouncements** has encouraged a short-term outlook in the valuation and financial statement classification of securities holdings. This has led to frequent income statement charges neither readily understood nor reasonably assessable by financial statement users. The effect has been to destabilize and create greater and damaging volatility in the reported results of businesses—particularly when these investments are being managed for the long term, with their financial security necessarily evaluated in this context.
- The long-standing **failure of one size fits all accounting** for real—though unpredictable—exposures to economic loss, has perpetuated a grievous mismatch of long-cycled revenues and expenses, and led to a misallocation of future-directed financial resources. Generally accepted accounting principles (GAAP) has failed to protect the public interest in products such as property insurance policies covering exposures to natural catastrophes like windstorms and earthquakes, or long duration financial indemnity policies covering the timely payment of mortgage or other long-term debt. By not allowing companies to set aside appropriate reserves from each year's premiums to cover the likely occurrences of future losses, GAAP has effectively aided and abetted financial institutions' adoption of a short-term mindset. This has exposed shareholders' capital and other people's money to the likelihood of potentially disastrous losses: 1) in paying dividends or bonuses from income that may ultimately prove to have been illusory; 2) in depleting the capital cushions of stewardship through short sighted stock buy-back strategies; and 3) in otherwise focusing on the "here and now" rather than the longevity of their promises of financial indemnity to assureds, depositors, and creditors.

The damage that these failings have caused to many of America's vaunted banking institutions and other financial intermediaries has reverberated throughout the economy. They will be seen as legendary when the history of these times is written.

Exceptionally challenging times, however, can present opportunities to reassess the premises of past conventions and assumptions. Clearly, accounting and financial engineering practices need to be scrutinized and brought to account to assure the veracity and consistency of financial reports that many rely upon. A great deal needs to be done to eliminate the opacity of unregulated and sometimes ill-conceived financial products that are also a root cause of the current economic difficulties.

Old Republic's business was not immune to the repercussions. While the Company's balance sheet and income statement were not tainted by holdings of questionable financial instruments, the business still sustained significant direct and collateral damage from the economic dislocations. Direct damage came from consumers' growing failures to honor their debt obligations—resulting from poor and at times fraudulent lending practices, which caused excessive borrowings that could not be covered by a family's income. Collateral damage came from the accelerating decline in home values propped up by these same practices.

As insurance underwriters, we have a "can do" optimistic streak. We remain convinced that a combination of U.S. Government policies properly designed to stabilize financial markets, and the resiliency of our free enterprise system, will undoubtedly lead to more favorable prospects for the nation's economy. From Old Republic's perspective, however, we currently expect that significant earnings improvements, shareholder account returns, and growth are not likely to emerge before mid-year 2010 at the earliest, with 2011 probably a better bet.

2008 Performance = 2007 Redux with Red Ink

Old Republic's 2008 quarterly reports foretold the results for the full year through a reasonably consistent trend line.

General Insurance operating income last year was affected mainly by moderately lower earned premiums and higher claim ratios. Earned premiums trended down throughout the year. This reflected a declining rate environment for most commercial insurance prices during the past three years or so, which hindered retention of some business and precluded meaningful additions to Old Republic's premium base.

The lower top line was accompanied by a rise in the overall claim ratio to 73.0 percent in 2008, compared with an average of 66.8 percent for the five years ended in 2007. Last year's higher claim ratio reflected the greater loss costs for most insurance coverages and the cumulative effect of softening premium rates. The increase in loss costs was most accentuated, however, in our consumer credit indemnity coverage. Underwriting and other expenses remained under good overall control, with the resulting 2008 expense ratio of 24.2 percent comparing favorably with the average of 24.8 percent registered in the five years through 2007. While somewhat higher than average, the 2008 composite underwriting ratio of 97.2 percent marked the seventh consecutive year of general insurance underwriting profitability.

Beginning mid-year 2008, **Mortgage Guaranty** premium growth slowed measurably due to lower mortgage originations, the increasingly more selective underwriting guidelines we applied, and from competing products offered by the Federal Housing Administration (FHA)—which reduced the amount of business available to the private mortgage guaranty sector.

The cyclical downturn in the housing and related mortgage finance industries resulted in higher mortgage guaranty claim costs for 2008. These costs reflect the combination of unfavorable loan default trends, greater claim severity caused by the larger insured loan values of recent years, and fewer opportunities to mitigate reported claims. Inflated inventories of unsold homes, weakening home values, and a more restrictive credit environment were the main causes for reduced mitigation opportunities—despite greater numbers of claims being rescinded due to fraud and material deviations from contractually required underwriting standards. As of December 31, 2008, net claim reserves of \$1.38 billion were 114.4 percent higher than they were 12 months earlier.

Lower mortgage guaranty production and operating expense ratios for 2008 continued to be a bright spot in operating trends, as higher premium volume was not accompanied by a corresponding increase in operating costs. The beneficial effect of the relatively lower expense ratios, however, was more than offset by the severe impact of rising claim ratios.

All of these factors combined to produce a continuing uptrend in this segment's composite underwriting ratio, which reached 215.0 percent versus an average of 74.0 percent for the five years ended December 31, 2007. Underwriting results notwithstanding, Old Republic's Mortgage Guaranty segment continued to post strong operating cash flows. These added to a high quality and liquid invested asset base: \$2.08 billion at December 31, 2008, up 14.6 percent from one year earlier. This greater invested asset base was mainly responsible for this segment's investment income growth in 2008.

The cyclical downturn in housing and related mortgage lending also led to year-over-year reductions of premium and fee revenues for the Company's **Title Insurance** segment. Direct production facilities in the Western United States continued to take the worst bottom line hits in this downturn. Claim ratios in 2008 trended up slightly as they did for all of 2007. While overall 2008 production and operating expenses have dropped significantly, the decline was not enough to counter the somewhat larger reduction in title premium and fee revenues.

In combination, Old Republic's segments produced net operating results printed with red ink for the first time in 33 years. The positive effects of product diversification that have been a mainstay of our long-term strategy could not offset the rapid deterioration of underwriting results from the housing and mortgage-related portions of our business. Together with the mark-to-market income statement charges from our securities' portfolio mentioned earlier, and the other entries shown below, the common shareholders' account declined by 17.6 percent (19.3 percent per share) in 2008:

	Total (\$ Millions)	Per Share
Common shareholders equity at December 31, 2007	\$ 4,541.6	\$ 19.71
2008 Changes:		
Net operating (loss)	(188.1)	(0.81)
Investment (losses):		
From securities sales	(2.7)	(0.01)
From mark-to-market impairments	(367.5)	(1.59)
Sub-total	(558.3)	(2.41)
Unrealized investment losses	(78.1)	(0.33)
Cash dividends paid	(155.2)	(0.67)
Other – net	(9.5)	(0.39)
Net 2008 change	(801.2)	(3.80)
Common shareholders equity at December 31, 2008	\$ 3,740.3	\$ 15.91

Financial Strength for the Long Run

The decline in Old Republic's shareholders' equity account notwithstanding, capital resources remain strong and flexible. At year-end 2008, outstanding debt—most of which consisted of short-term commercial paper—amounted to just 6.2 percent of shareholders' equity. At this relatively low level, Old Republic can increase its debt if necessary and still remain within reasonable balance sheet leverage guideposts.

Our balance sheet retains its long standing pristine state. Further damage from mark-to-market adjustments to the equities portfolio is not expected to affect the capital account to a significant degree in 2009. Other assets—mainly a high quality bond portfolio and recoverables from reinsured business transactions—should likewise provide ample support for the liabilities they fund. On the liability side of the balance sheet, prior-year loss development experience is providing a great deal of comfort that existing claim reserve levels should prove adequate to cover the recorded obligations.

Stock Market Valuation of Old Republic's Stock

Last year's equities markets punished most common stocks. The Standard & Poor's 500 Index, including reinvested dividends, was down 37.0 percent. Old Republic's total market return, also including dividends paid to our shareholders, was down 18.2 percent. At the year-end 2008's quoted price of \$11.92 per share, Old Republic's common stock yielded 5.7 percent based on the annual dividend rate of \$0.68 per share.

The carnage in stock valuations continued unabated in the early part of 2009, as the shares of most banking, insurance, and other financial institutions in particular succumbed to an atmosphere of doom and gloom. While it is impossible to project the future level of stock prices, we remain confident that the Company's good long-term prospects and the staying power of its franchise will provide greater market-driven rewards over time.

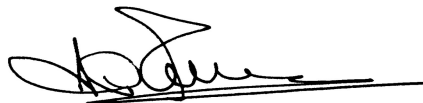
Outlook for Our Business

As discussed throughout this letter, the near-term outlook for the American economy is colored by substantial dislocations in the financial and other sectors—including housing and construction, in which Old Republic has significant involvements. In our view, there are major impediments to a quick fix of the many issues that have contributed to disrupt and disorient the economy. It took perhaps the decade through 2006 for the many issues to reach their current state. It will surely take several years to straighten out what has been bent.

In this context, Old Republic's financial and housing-related businesses of mortgage guaranty and consumer credit indemnity in particular will continue to face strong headwinds in 2009 and, most likely, for part of 2010. Our reality check leads us to conclude that these insurance lines will produce sufficiently negative results that will offset the expected positive contributions of most other insurance coverages we underwrite. Early in 2009, our best guess is that Old Republic will report negative operating results for the year, although these may be moderately better than those posted in 2008. Last year's net results were also burdened to a significant degree by charges stemming from mark-to-market accounting adjustments. Because the markdowns were sufficiently broad based, we have much lower exposure to any possible 2009 downgrades. In sum: while our business will face continued difficulties in 2009, we have every confidence that Old Republic's strong capitalization will weather the current economic storm.

In these difficult times, many of our associates are working much harder than usual, stretching resources and make do with a lot less, and staying focused while trusting that we will reach more navigable waters. They are doing all this in exemplary fashion—for which we are immensely grateful. Our thankfulness also extends to long-term shareholders, who continue to entrust us with the stewardship of their investment in Old Republic.

Respectfully submitted on behalf of the
Company and its Board of Directors,



Aldo C. Zucaro
Chairman and Chief Executive Officer

Chicago, Illinois
February 26, 2009