

RLI CORP  
Form 10-Q  
October 29, 2012

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2012

\_\_\_\_\_

or

**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)

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**ILLINOIS**  
(State or other jurisdiction of  
incorporation or organization)

**37-0889946**  
(I.R.S. Employer  
Identification Number)

**9025 North Lindbergh Drive, Peoria, IL**  
(Address of principal executive offices)

**61615**  
(Zip Code)

**(309) 692-1000**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

As of October 12, 2012, the number of shares outstanding of the registrant's Common Stock was 21,222,684.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

| (in thousands, except per share data)   | For the Three-Month Periods<br>Ended September 30, |            |
|---|--|------------|
|   | 2012   | 2011       |
| Net premiums earned   | \$ 149,943   | \$ 146,552 |
| Net investment income   | 14,221   | 15,954     |
| Net realized investment gains   | 5,481  | 80         |
| Other-than-temporary impairment (OTTI) losses on investments                  |  | (257)      |
| Consolidated revenue  | 169,645  | 162,329    |
| Losses and settlement expenses  | 70,598   | 64,802     |
| Policy acquisition costs  | 49,262   | 49,924     |
| Insurance operating expenses  | 11,553   | 10,302     |
| Interest expense on debt  | 1,512  | 1,513      |
| General corporate expenses  | 2,099  | 1,594      |
| Total expenses  | 135,024  | 128,135    |
| Equity in earnings of unconsolidated investee                                 | 1,859  | 713        |
| Earnings before income taxes  | 36,480   | 34,907     |
| Income tax expense  | 11,017   | 10,938     |
| Net earnings  | \$ 25,463  | \$ 23,969  |
| Other comprehensive earnings (loss), net of tax                               |  |            |
| Unrealized gains (losses) on securities:                                      |  |            |
| Unrealized holding gains (losses) arising during the period                   | 25,127   | (14,518)   |
| Less: Reclassification adjustment for (gains) losses included in net earnings | (4,080)  | 187        |
| Other comprehensive earnings (loss)   | 21,047   | (14,331)   |
| Comprehensive earnings  | \$ 46,510  | \$ 9,638   |
| Earnings per share:   |  |            |
| Basic:  |  |            |
| Basic net earnings per share  | \$ 1.20  | \$ 1.14    |
| Basic comprehensive earnings per share  | \$ 2.19  | \$ 0.46    |
| Diluted:  |  |            |
| Diluted net earnings per share  | \$ 1.19  | \$ 1.12    |
| Diluted comprehensive earnings per share                                      | \$ 2.16  | \$ 0.45    |
| Weighted average number of common shares outstanding                          |  |            |
| Basic   | 21,218   | 21,089     |
| Diluted   | 21,486   | 21,335     |

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|  |    |      |    |      |
|--|----|------|----|------|
| Cash dividends declared per common share | \$ | 0.32 | \$ | 0.30 |
|--|----|------|----|------|

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

| (in thousands, except per share data)                                | For the Nine-Month Periods<br>Ended September 30, |            |
|--|---|------------|
|  | 2012  | 2011       |
| Net premiums earned  | \$ 428,807  | \$ 393,429 |
| Net investment income  | 44,340  | 47,437     |
| Net realized investment gains  | 17,389  | 14,602     |
| Other-than-temporary impairment (OTTI) losses on investments         | (1,156)   | (257)      |
| Consolidated revenue   | 489,380   | 455,211    |
| Losses and settlement expenses                                       | 193,486   | 142,036    |
| Policy acquisition costs   | 145,632   | 134,785    |
| Insurance operating expenses   | 34,595  | 32,047     |
| Interest expense on debt   | 4,537   | 4,537      |
| General corporate expenses   | 5,901   | 5,563      |
| Total expenses   | 384,151   | 318,968    |
| Equity in earnings of unconsolidated investee                        | 8,928   | 7,215      |
| Earnings before income taxes   | 114,157   | 143,458    |
| Income tax expense   | 35,908  | 46,791     |
| Net earnings   | \$ 78,249   | \$ 96,667  |
| Other comprehensive earnings (loss), net of tax                      |   |            |
| Unrealized gains (losses) on securities:                             |   |            |
| Unrealized holding gains arising during the period                   | 50,066  | 2,860      |
| Less: Reclassification adjustment for gains included in net earnings | (12,353)  | (9,183)    |
| Other comprehensive earnings (loss)                                  | 37,713  | (6,323)    |
| Comprehensive earnings   | \$ 115,962  | \$ 90,344  |
| Earnings per share:  |   |            |
| Basic:   |   |            |
| Basic net earnings per share   | \$ 3.69   | \$ 4.59    |
| Basic comprehensive earnings per share                               | \$ 5.47   | \$ 4.29    |
| Diluted:   |   |            |
| Diluted net earnings per share                                       | \$ 3.64   | \$ 4.53    |
| Diluted comprehensive earnings per share                             | \$ 5.39   | \$ 4.24    |
| Weighted average number of common shares outstanding                 |   |            |
| Basic  | 21,207  | 21,063     |
| Diluted  | 21,519  | 21,324     |
| Cash dividends declared per common share                             | \$ 0.94   | \$ 0.89    |

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



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RLI Corp. and Subsidiaries Condensed Consolidated Balance Sheets

(Unaudited)

| (in thousands, except share data)                                     | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Investments   |                       |                      |
| Fixed income  |                       |                      |
| Available-for-sale, at fair value                                     | \$ 1,432,969          | \$ 1,146,317         |
| Held-to-maturity, at amortized cost                                   | 11,724                | 260,226              |
| Trading, at fair value  | 7                     | 7                    |
| Equity securities, at fair value                                      | 402,099               | 388,689              |
| Short-term investments, at cost                                       | 82,202                | 23,865               |
| Cash  | 31,301                | 81,184               |
| Total investments and cash  | 1,960,302             | 1,900,288            |
| Accrued investment income   | 13,071                | 13,865               |
| Premiums and reinsurance balances receivable                          | 158,871               | 124,496              |
| Ceded unearned premium  | 73,082                | 61,629               |
| Reinsurance balances recoverable on unpaid losses                     | 336,612               | 353,805              |
| Deferred policy acquisition costs                                     | 55,777                | 52,105               |
| Property and equipment  | 25,218                | 20,104               |
| Investment in unconsolidated investee                                 | 58,242                | 49,968               |
| Goodwill and intangibles  | 59,780                | 60,482               |
| Other assets  | 13,199                | 18,092               |
| <b>TOTAL ASSETS</b>   | <b>\$ 2,754,154</b>   | <b>\$ 2,654,834</b>  |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>                            |                       |                      |
| Liabilities:  |                       |                      |
| Unpaid losses and settlement expenses                                 | \$ 1,134,593          | \$ 1,150,714         |
| Unearned premiums   | 384,414               | 341,267              |
| Reinsurance balances payable  | 65,793                | 50,861               |
| Funds held  | 57,604                | 110,555              |
| Income taxes-deferred   | 63,553                | 37,867               |
| Bonds payable, long-term debt   | 100,000               | 100,000              |
| Accrued expenses  | 45,499                | 58,883               |
| Other liabilities   | 8,329                 | 12,053               |
| <b>TOTAL LIABILITIES</b>  | <b>\$ 1,859,785</b>   | <b>\$ 1,862,200</b>  |
| Shareholders Equity   |                       |                      |
| Common stock (\$1 par value, 100,000,000 shares authorized)           | 32,686                | 32,627               |
| (32,685,588 shares issued, 21,220,481 shares outstanding at 9/30/12)  |                       |                      |
| (32,627,244 shares issued, 21,162,137 shares outstanding at 12/31/11) |                       |                      |
| Paid-in capital   | 233,442               | 227,788              |
| Accumulated other comprehensive earnings                              | 155,038               | 117,325              |
| Retained earnings   | 866,202               | 807,893              |
| Deferred compensation   | 10,175                | 10,445               |
| Less: Treasury shares at cost   | (403,174)             | (403,444)            |
| (11,465,107 shares at 9/30/12)  |                       |                      |
| (11,465,107 shares at 12/31/11)                                       |                       |                      |
| <b>TOTAL SHAREHOLDERS EQUITY</b>                                      | <b>894,369</b>        | <b>792,634</b>       |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>                      | <b>\$ 2,754,154</b>   | <b>\$ 2,654,834</b>  |

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





RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

| (in thousands)                                    | For the Nine-Month Periods<br>Ended September 30, |             |
|---|---|-------------|
|   | 2012  | 2011        |
| Net cash provided by operating activities         | \$ 13,154   | \$ 115,922  |
| Cash Flows from Investing Activities              |   |             |
| Investments purchased                             | (628,331)   | (608,538)   |
| Investments sold                                  | 180,641   | 353,781     |
| Investments called or matured                     | 469,041   | 340,321     |
| Net change in short-term investments              | (59,088)  | (45,612)    |
| Net property and equipment purchased              | (11,073)  | (2,507)     |
| Investment in CBIC                                |   | (135,900)   |
| Net cash used in investing activities             | \$ (48,810)                                       | \$ (98,455) |
| Cash Flows from Financing Activities              |   |             |
| Cash dividends paid                               | \$ (19,940)                                       | \$ (18,757) |
| Stock option plan share issuance                  | 4,842   | 4,754       |
| Excess tax benefit from exercise of stock options | 871   | 3,160       |
| Treasury shares purchased                         |   | (6,624)     |
| Net cash used in financing activities             | \$ (14,227)                                       | \$ (17,467) |
| Net decrease in cash                              | (49,883)  |             |
| Cash at the beginning of the period               | 81,184  |             |
| Cash at September 30                              | \$ 31,301   | \$          |

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

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**A. BASIS OF PRESENTATION**

The unaudited condensed consolidated interim financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 2011 Annual Report on Form 10-K. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position at September 30, 2012 and the results of operations of RLI Corp. and Subsidiaries for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the operating results for a full year.

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

**B. ADOPTED ACCOUNTING STANDARDS**

*ASU 2010-26, Financial Services – Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*

Accounting guidance for deferred acquisition costs incurred by insurance entities changed under this Accounting Standards Update (ASU) and was designed to eliminate inconsistent industry practices. The ASU requires costs to be incrementally or directly related to the successful acquisition of new or renewal insurance contracts in order to be capitalized as deferred acquisition costs.

We adopted this new accounting standard effective January 1, 2012 on a retrospective basis. Our adoption of the new standard resulted in a \$40.3 million reduction of deferred policy acquisition costs asset and a \$26.2 million decrease to consolidated shareholders' equity, net of a \$14.1 million deferred income tax benefit at December 31, 2011. The adjustment to shareholders' equity resulted in a reduction in book value of \$1.24 per share, based on the number of shares outstanding at January 1, 2012.

As of January 1, 2011, the beginning of the earliest period presented in these interim financial statements, the cumulative effect of our adoption of the new standard was a \$22.2 million reduction to consolidated shareholders' equity at December 31, 2010. The adjustment to shareholders' equity resulted in a reduction in book value of \$1.06 per share, based on the number of shares outstanding at January 1, 2011. While not presented in this filing, the



December 31, 2010 balance sheet will be revised as part of our 2012 annual filing.

The new standard affects the timing of the recognition of policy acquisition costs. Costs associated with unsuccessful efforts or costs that cannot be tied directly to a successful policy acquisition are treated as period costs and expensed as incurred, as opposed to being deferred and amortized as the premium is earned. In periods of expansion, the new standard will result in an acceleration of expense recognition. In periods of contraction, the inverse will occur.

All comparative period information presented has been revised to reflect changes due to our adoption of this guidance. Comparative period information for the third quarter of 2011 has been revised to reflect changes resulting from our retrospective adoption of the new accounting standard. The third quarter of 2011 was a period in which premium and business were expanding. As a result, the application of the new standard resulted in a \$3.2 million increase in policy acquisition costs recognized in the revised third quarter of 2011 and a corresponding 2.2 point increase to our revised combined ratio. The revised net earnings decreased by \$2.1 million, or \$0.10 per share. For the nine month period ended September 30, 2011, the application of the new standard resulted in a \$5.0 million increase to policy acquisition costs, a 1.3 point increase to our combined ratio, and a \$3.2 million, or \$0.15 per share, decrease to net earnings. From a current year perspective, the impact of applying the new standard to the third quarter of 2012 resulted in an increase of approximately \$0.3 million in policy acquisition costs recognized, which decreased net earnings by \$0.01 per share. For the nine month period ended September 30, 2012, policy acquisition costs recognized have increased \$3.8 million, which decreased net earnings by \$0.12 per share. Going forward the impact of this new standard will vary based on expansion or contraction, as well as changes in mix of business.

*ASU 2011-08, Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*

This ASU, issued on September 15, 2011, permits an entity to make a qualitative assessment of whether it is more-likely-than-not that a reporting unit's fair value is less than its carrying amount before applying the two-step goodwill impairment test. If an entity can support the conclusion that it is more-likely-than-not that the fair value of a reporting unit is greater than its carrying amount, it would not need to perform the two-step impairment test for that reporting unit. Goodwill must be tested for impairment at least annually, and prior to this ASU, a two-step test was required to assess goodwill for impairment. In step one, the fair value of a reporting unit is compared to the reporting unit's carrying amount. If the fair value is less than the carrying amount, step two is used to measure the amount of goodwill impairment, if any.

We adopted ASU 2011-08 on January 1, 2012. The adoption did not have an impact on our financial statements. There have been no triggering events that would suggest possible impairment or that it is more-likely-than-not that the fair values of the reporting units related to our goodwill are less than their carrying amounts. We utilized the new guidance during our annual impairment testing in the second quarter of 2012.

*ASU 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income*

This ASU was issued to increase the prominence of other comprehensive income in financial statements and to help financial statement users better understand the causes of an entity's change in financial position and results of operations. Under the standard, an entity is required to present the components of net income and other comprehensive income in either one continuous statement or two separate but consecutive financial statements. In December 2011, ASU 2011-12 was issued in order to defer the effective date of specific provisions of ASU 2011-05 related to the presentation of reclassification adjustments. Both standards are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The new requirements do not have a material effect on our financial statements, and we adopted the standards effective with our first quarter 2012 interim filing.

C. PROSPECTIVE ACCOUNTING STANDARDS

*ASU 2012-02, Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*

This ASU permits an entity the option to first assess qualitative factors to determine whether it is more-likely-than-not that an indefinite-lived intangible asset is impaired. The results of the qualitative assessment would be used as a basis in determining whether it is necessary to perform the two-step quantitative impairment test. If the qualitative assessment supports the conclusion that it is more-likely-than-not that the fair value of the asset exceeds its carrying amount, the entity would not need to perform the two-step quantitative impairment test. The focus of the guidance is to reduce the cost and complexity of performing impairment tests for indefinite-lived intangible assets other than goodwill, and to improve consistency in impairment testing among long-lived asset categories.

This ASU is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed prior to the issuance of the final ASU, if an entity's financial statements for the most recent annual or interim period have not yet been issued. We have not early-adopted this ASU and do not believe adoption will have a material effect on our financial statements.

D. INTANGIBLE ASSETS

In accordance with GAAP guidelines, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. The portion of goodwill which relates solely to our surety segment totaled \$26.2 million at September 30, 2012 and December 31, 2011 and is included in the total goodwill and intangibles on the balance sheet of \$59.8 million at September 30, 2012 and \$60.5 million at December 31, 2011. Annual impairment testing was performed during the second quarter of 2012. Based upon this review, this asset was not

impaired. In addition, as of September 30, 2012, there were no triggering events that had occurred that would suggest an updated review was necessary.

The remaining \$33.6 million of goodwill and intangibles relates to both our casualty and surety segments, in connection with the purchase of CBIC in April 2011. Goodwill attributable to our casualty and surety segments totaled \$5.3 million and \$15.1 million, respectively. An indefinite-lived intangible asset in the amount of \$8.8 million was also recorded in connection with the CBIC acquisition. Annual impairment testing was performed on each of the goodwill and indefinite-lived intangible assets in the second quarter of 2012. Based upon these reviews, none of the assets were impaired. In addition, as of September 30, 2012, there were no triggering events that had occurred that would suggest an updated review was necessary.

Intangible assets with definite lives are amortized against future operating results. Amortization of intangible assets was \$0.2 million for the third quarter of 2012, and \$0.7 million for the nine months ended September 30, 2012. In addition to these assets, the acquisition of CBIC resulted in a value of business acquired (VOBA) asset, which is also being amortized.

E. EARNINGS PER SHARE

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

The following represents a reconciliation of the numerator and denominator of the basic and diluted EPS computations contained in the unaudited condensed consolidated financial statements.

| (in thousands, except per share data)   | For the Three-Month Period Ended September 30, 2012 |                      |                  | For the Three-Month Period Ended September 30, 2011 |                      |                  |
|---|---|----------------------|------------------|---|----------------------|------------------|
|   | Income (Numerator)                                  | Shares (Denominator) | Per Share Amount | Income (Numerator)                                  | Shares (Denominator) | Per Share Amount |
| <b>Basic EPS</b>                        |   |                      |                  |   |                      |                  |
| Income available to common shareholders | \$ 25,463   | 21,218               | \$ 1.20          | \$ 23,969   | 21,089               | \$ 1.14          |
| <b>Effect of Dilutive Securities</b>    |   |                      |                  |   |                      |                  |
| Stock Options                           |   | 268                  |                  |   | 246                  |                  |
| <b>Diluted EPS</b>                      |   |                      |                  |   |                      |                  |
| Income available to common shareholders | \$ 25,463   | 21,486               | \$ 1.19          | \$ 23,969   | 21,335               | \$ 1.12          |

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| (in thousands, except per share data)   | For the Nine-Month Period Ended September 30, 2012 |                      |                  | For the Nine-Month Period Ended September 30, 2011 |                      |                  |
|---|--|----------------------|------------------|--|----------------------|------------------|
|   | Income (Numerator)                                 | Shares (Denominator) | Per Share Amount | Income (Numerator)                                 | Shares (Denominator) | Per Share Amount |
| <b>Basic EPS</b>                        |  |                      |                  |  |                      |                  |
| Income available to common shareholders | \$ 78,249  | 21,207               | \$ 3.69          | \$ 96,667  | 21,063               | \$ 4.59          |
| <b>Effect of Dilutive Securities</b>    |  |                      |                  |  |                      |                  |
| Stock options                           |  | 312                  |                  |  | 261                  |                  |
| <b>Diluted EPS</b>                      |  |                      |                  |  |                      |                  |
| Income available to common shareholders | \$ 78,249  | 21,519               | \$ 3.64          | \$ 96,667  | 21,324               | \$ 4.53          |

## 2. INVESTMENTS

Our investments include fixed income debt securities and common stock equity securities. As disclosed in our 2011 Annual Report on Form 10-K, we present our investments in these classes as available-for-sale, held-to-maturity, or trading securities. When available, we obtain quoted market prices to determine fair value for our investments. If a quoted market price is not available, fair value is estimated using a secondary pricing source or using quoted market prices of similar securities. We have no investment securities for which fair value is determined using Level 3 inputs as defined in note 3 to the unaudited condensed consolidated interim financial statements, Fair Value Measurements.

The following tables show the amortized cost, unrealized gains/losses, fair value and contractual maturities for our available-for-sale and held-to-maturity securities.

### *Available-for-Sale Securities*

The amortized cost and fair value of securities available-for-sale at September 30, 2012 and December 31, 2011 were as follows:

### Available-for-sale

(in thousands)

| Asset Class     | 9/30/2012              |                        |                         |            |
|-----------------|------------------------|------------------------|-------------------------|------------|
|                 | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| U.S. agencies   | \$ 19,632              | \$ 182                 | \$                      | \$ 19,814  |
| Corporates      | 543,236                | 48,063                 | (229)                   | 591,070    |
| Mortgage-backed | 253,610                | 18,665                 |                         | 272,275    |
| ABS/CMO*        | 82,752                 | 4,949                  |                         | 87,701     |

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|   |                     |                   |                   |                     |
|---|---------------------|-------------------|-------------------|---------------------|
| Non-U.S. govt. & agency                     | 8,408               | 880               | 9,288             |                     |
| U.S. government                             | 16,359              | 393               | 16,752            |                     |
| States, political subdivisions and revenues | 418,092             | 18,022            | (45)              | 436,069             |
| <b>Total Fixed Income</b>                   | <b>\$ 1,342,089</b> | <b>\$ 91,154</b>  | <b>\$ (274)</b>   | <b>\$ 1,432,969</b> |
| <b>Equities</b>                             | <b>\$ 254,428</b>   | <b>\$ 148,720</b> | <b>\$ (1,049)</b> | <b>\$ 402,099</b>   |



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**Available-for-sale**

(in thousands)

| Asset Class                                 | 12/31/2011             |                        |                         |                     |
|---|------------------------|------------------------|-------------------------|---------------------|
|   | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value          |
| U.S. agencies                               | \$ 112,975             | \$ 844                 | \$                      | \$ 113,819          |
| Corporates                                  | 439,079                | 31,640                 | (3,619)                 | 467,100             |
| Mortgage-backed                             | 233,134                | 15,852                 |                         | 248,986             |
| ABS/CMO*                                    | 54,325                 | 2,628                  |                         | 56,953              |
| Non-U.S. govt. & agency                     | 6,403                  | 294                    |                         | 6,697               |
| U.S. government                             | 15,721                 | 459                    | (8)                     | 16,172              |
| States, political subdivisions and revenues | 224,091                | 12,517                 | (18)                    | 236,590             |
| <b>Total Fixed Income</b>                   | <b>\$ 1,085,728</b>    | <b>\$ 64,234</b>       | <b>\$ (3,645)</b>       | <b>\$ 1,146,317</b> |
| <b>Equities</b>                             | <b>\$ 269,400</b>      | <b>\$ 121,833</b>      | <b>\$ (2,544)</b>       | <b>\$ 388,689</b>   |

\*Asset-backed and collateralized mortgage obligations

The following table presents the amortized cost and fair value of available-for-sale debt securities by contractual maturity dates as of September 30, 2012:

| AFS<br>(in thousands)                 | 9/30/2012      |              |
|---------------------------------------|----------------|--------------|
|                                       | Amortized Cost | Fair Value   |
| Due in one year or less               | \$ 25,304      | \$ 25,393    |
| Due after one year through five years | 127,050        | 133,778      |
| Due after five years through 10 years | 662,829        | 714,560      |
| Due after 10 years                    | 190,544        | 199,262      |
| Mtge/ABS/CMO*                         | 336,362        | 359,976      |
| Total available-for-sale              | \$ 1,342,089   | \$ 1,432,969 |

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

*Held-to-Maturity Debt Securities*

The carrying value and fair value of held-to-maturity securities at September 30, 2012 and December 31, 2011 were as follows:

**Held-to-maturity**

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(in thousands)

| Asset Class                                 | 9/30/2012                           |                                |                                 |                  |
|---|-------------------------------------|--------------------------------|---------------------------------|------------------|
|   | Amortized Cost/<br>Carrying Value** | Gross<br>Unrecognized<br>Gains | Gross<br>Unrecognized<br>Losses | Fair<br>Value    |
| U.S. agencies                               | \$ 10,071                           | \$ 135                         | \$                              | \$ 10,206        |
| Corporates                                  |                                     |                                |                                 |                  |
| Mortgage-backed<br>ABS/CMO*                 |                                     |                                |                                 |                  |
| Non-U.S. govt. & agency                     |                                     |                                |                                 |                  |
| U.S. government                             |                                     |                                |                                 |                  |
| States, political subdivisions and revenues | 1,653                               | 87                             |                                 | 1,740            |
| <b>Total Fixed Income</b>                   | <b>\$ 11,724</b>                    | <b>\$ 222</b>                  | <b>\$</b>                       | <b>\$ 11,946</b> |

**Held-to-maturity**

(in thousands)

| Asset Class  | 12/31/2011                          |                                |                                 |                   |
|--|-------------------------------------|--------------------------------|---------------------------------|-------------------|
|  | Amortized Cost/<br>Carrying Value** | Gross<br>Unrecognized<br>Gains | Gross<br>Unrecognized<br>Losses | Fair<br>Value     |
| U.S. agencies  | \$ 243,571                          | \$ 1,085                       | \$                              | \$ 244,656        |
| Corporates   | 15,000                              |                                | (464)                           | 14,536            |
| Mortgage-backed<br>ABS/CMO*                                    |                                     |                                |                                 |                   |
| U.S. government<br>States, political subdivisions and revenues | 1,655                               | 134                            |                                 | 1,789             |
| <b>Total Fixed Income</b>                                      | <b>\$ 260,226</b>                   | <b>\$ 1,219</b>                | <b>\$ (464)</b>                 | <b>\$ 260,981</b> |

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\*Asset-backed and collateralized mortgage obligations

\*\* Held-to-maturity securities are carried on the unaudited condensed consolidated balance sheets at amortized cost and changes in the fair value of these securities, other than impairment charges, are not reported on the financial statements.

The following table presents the carrying value and fair value of debt securities held-to-maturity by contractual maturity dates as of September 30, 2012:

| HTM<br>(in thousands)                 | 9/30/2012         |               |
|---------------------------------------|-------------------|---------------|
|                                       | Amortized<br>Cost | Fair<br>Value |
| Due in one year or less               | \$ 2,992          | \$ 3,065      |
| Due after one year through five years | 652               | 727           |
| Due after five years through 10 years |                   |               |
| Due after 10 years                    | 8,080             | 8,154         |
| Mtge/ABS/CMO*                         |                   |               |
| Total held-to-maturity                | \$ 11,724         | \$ 11,946     |

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

We conduct and document periodic reviews of all securities with unrealized losses to evaluate whether the impairment is other-than-temporary. The following tables are used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of September 30, 2012 and December 31, 2011. The tables segregate the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position. As of September 30, 2012 and December 31, 2011, unrealized losses, as shown in the following tables, were less than 1% of total invested assets. Unrealized losses have decreased in 2012, as equity markets have increased while the market value of our fixed income securities has increased as interest rates have decreased during the year.



**Investment Positions with Unrealized Losses****Segmented by Type and Period of Continuous****Unrealized Loss at September 30, 2012**

| (dollars in thousands)                             | < 12 Mos. | 12 Mos. & Greater | Total   |
|--|-----------|-------------------|---------|
| <b>U.S. Government</b>                             |           |                   |         |
| Fair value   | \$        | \$                | \$      |
| Cost or Amortized Cost                             |           |                   |         |
| Unrealized Loss                                    |           |                   |         |
| <b>U.S. Agency</b>                                 |           |                   |         |
| Fair value   | \$        | \$                | \$      |
| Cost or Amortized Cost                             |           |                   |         |
| Unrealized Loss                                    |           |                   |         |
| <b>Non-U.S. govt. &amp; agency</b>                 |           |                   |         |
| Fair value   | \$        | \$                | \$      |
| Cost or Amortized Cost                             |           |                   |         |
| Unrealized Loss                                    |           |                   |         |
| <b>Mortgage-backed</b>                             |           |                   |         |
| Fair value   | \$        | \$                | \$      |
| Cost or Amortized Cost                             |           |                   |         |
| Unrealized Loss                                    |           |                   |         |
| <b>ABS/CMO*</b>                                    |           |                   |         |
| Fair value   | \$        | 27                | \$      |
| Cost or Amortized Cost                             |           | 27                | 27      |
| Unrealized Loss                                    |           |                   |         |
| <b>Corporate</b>                                   |           |                   |         |
| Fair value   | \$        | 22,504            | \$      |
| Cost or Amortized Cost                             |           | 22,536            | 3,760   |
| Unrealized Loss                                    |           | (32)              | (197)   |
| <b>States, political subdivisions and revenues</b> |           |                   |         |
| Fair value   | \$        | 20,530            | \$      |
| Cost or Amortized Cost                             |           | 20,575            | 20,530  |
| Unrealized Loss                                    |           | (45)              | (45)    |
| <b>Subtotal, debt securities</b>                   |           |                   |         |
| Fair value   | \$        | 43,061            | \$      |
| Cost or Amortized Cost                             |           | 43,138            | 3,760   |
| Unrealized Loss                                    |           | (77)              | (197)   |
| <b>Common Stock</b>                                |           |                   |         |
| Fair value   | \$        | 21,425            | \$      |
| Cost or Amortized Cost                             |           | 22,474            | 21,425  |
| Unrealized Loss                                    |           | (1,049)           | (1,049) |
| <b>Total</b>                                       |           |                   |         |
| Fair value   | \$        | 64,486            | \$      |
|  |           | 3,760             | \$      |
|  |           | (197)             | 68,246  |

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|                        |         |       |         |
|------------------------|---------|-------|---------|
| Cost or Amortized Cost | 65,612  | 3,957 | 69,569  |
| Unrealized Loss        | (1,126) | (197) | (1,323) |

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\* Asset-backed & collateralized mortgage obligations.

This table excludes securities with a fair value of less than \$0.1 million classified as trading.

**Investment Positions with Unrealized Losses****Segmented by Type and Period of Continuous****Unrealized Loss at December 31, 2011**

| (dollars in thousands)                             | < 12 Mos. | 12 Mos. & Greater | Total      |
|--|-----------|-------------------|------------|
| <b>U.S. Government</b>                             |           |                   |            |
| Fair value   | \$ 5,023  | \$                | \$ 5,023   |
| Cost or Amortized Cost                             | 5,031     |                   | 5,031      |
| Unrealized Loss                                    | (8)       |                   | (8)        |
| <b>U.S. Agency</b>                                 |           |                   |            |
| Fair value   | \$        | \$                | \$         |
| Cost or Amortized Cost                             |           |                   |            |
| Unrealized Loss                                    |           |                   |            |
| <b>Non-U.S. govt. &amp; agency</b>                 |           |                   |            |
| Fair value   | \$        | \$                | \$         |
| Cost or Amortized Cost                             |           |                   |            |
| Unrealized Loss                                    |           |                   |            |
| <b>Mortgage-backed</b>                             |           |                   |            |
| Fair value   | \$        | \$                | \$         |
| Cost or Amortized Cost                             |           |                   |            |
| Unrealized Loss                                    |           |                   |            |
| <b>ABS/CMO *</b>                                   |           |                   |            |
| Fair value   | \$        | \$                | \$         |
| Cost or Amortized Cost                             |           |                   |            |
| Unrealized Loss                                    |           |                   |            |
| <b>Corporate</b>                                   |           |                   |            |
| Fair value   | \$ 49,464 | \$ 28,698         | \$ 78,162  |
| Cost or Amortized Cost                             | 51,894    | 30,351            | 82,245     |
| Unrealized Loss                                    | (2,430)   | (1,653)           | (4,083)    |
| <b>States, political subdivisions and revenues</b> |           |                   |            |
| Fair value   | \$        | \$ 1,050          | \$ 1,050   |
| Cost or Amortized Cost                             |           | 1,068             | 1,068      |
| Unrealized Loss                                    |           | (18)              | (18)       |
| <b>Subtotal, debt securities</b>                   |           |                   |            |
| Fair value   | \$ 54,487 | \$ 29,748         | \$ 84,235  |
| Cost or Amortized Cost                             | 56,925    | 31,419            | 88,344     |
| Unrealized Loss                                    | (2,438)   | (1,671)           | (4,109)    |
| <b>Common Stock</b>                                |           |                   |            |
| Fair value   | \$ 25,952 | \$                | \$ 25,952  |
| Cost or Amortized Cost                             | 28,496    |                   | 28,496     |
| Unrealized Loss                                    | (2,544)   |                   | (2,544)    |
| <b>Total</b>                                       |           |                   |            |
| Fair value   | \$ 80,439 | \$ 29,748         | \$ 110,187 |
| Cost or Amortized Cost                             | 85,421    | 31,419            | 116,840    |

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|                 |         |         |         |
|-----------------|---------|---------|---------|
| Unrealized Loss | (4,982) | (1,671) | (6,653) |
|-----------------|---------|---------|---------|

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\* Asset-backed & collateralized mortgage obligations.

This table excludes securities with a fair value of \$0.1 million, classified as trading.



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The following table shows the composition of the fixed income securities in unrealized loss positions at September 30, 2012 by the National Association of Insurance Commissioners (NAIC) rating and the generally equivalent Standard & Poor's (S&P) and Moody's ratings. The vast majority of the securities are rated by S&P and/or Moody's.

| NAIC Rating | Equivalent S&P Rating | Equivalent Moody's Rating | (dollars in thousands) |            |                 |                  |
|-------------|-----------------------|---------------------------|------------------------|------------|-----------------|------------------|
|             |                       |                           | Amortized Cost         | Fair Value | Unrealized Loss | Percent to Total |
| 1           | AAA/AA/A              | Aaa/Aa/A                  | \$ 47,095              | \$ 46,821  | \$ (274)        | 100.0%           |
| 2           | BBB                   | Baa                       |                        |            |                 |                  |
| 3           | BB                    | Ba                        |                        |            |                 |                  |
| 4           | B                     | B                         |                        |            |                 |                  |
| 5           | CCC or lower          | Caa or lower              |                        |            |                 |                  |
| 6           |                       |                           |                        |            |                 |                  |
|             |                       | Total                     | \$ 47,095              | \$ 46,821  | \$ (274)        | 100.0%           |

### *Cash and Short-term Investments*

Cash consists of uninvested balances in bank accounts. We had a cash balance of \$31.3 million at the end of the third quarter, compared to \$81.2 million at the end of 2011. Short-term investments are carried at cost, which approximates fair value. The balance at September 30, 2012 was \$82.2 million compared to \$23.9 million at December 31, 2011.

### *Evaluating Investments for OTTI*

The fixed income portfolio contained 22 securities in an unrealized loss position as of September 30, 2012. The \$0.3 million in associated unrealized losses for these 22 securities represents less than 0.1% of the fixed income portfolio's cost basis. Of these 22 securities, two have been in an unrealized loss position for 12 consecutive months or longer and these collectively represent \$0.2 million in unrealized losses. The unrealized losses on these two securities are primarily due to high liquidity premiums and wide bid/ask differentials. We believe the amortized cost of these two securities is fully recoverable under current assumptions. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. GAAP guidance requires any credit-related impairment related to fixed income securities we do not plan to sell and for which we are not more-likely-than-not to be required to sell be recognized in net earnings, with the non-credit related impairment recognized in comprehensive earnings. Based on our monitoring and analysis, our fixed income portfolio contains high quality bonds and we believe we will recover the amortized cost basis of these securities. We continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. There were no other-than-temporary impairment (OTTI) losses recognized in net earnings or other comprehensive earnings in the periods presented on the fixed income portfolio.

As of September 30, 2012, we held seven common stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled \$1.0 million. Based on our analysis, we believe these securities will recover in a reasonable period of time and we have the intent and ability to hold these

securities until recovery. Of the seven common stock positions that were in an unrealized loss position, none have been in an unrealized loss position for 12 consecutive months or longer.

While no securities were considered to be other-than-temporarily impaired during the third quarter, we recognized \$1.2 million in other-than-temporary impairment charges during the second quarter of 2012. All of these OTTI losses were on equity securities we no longer had the intent to hold, and were subsequently sold during the third quarter. Comparatively, we recognized \$0.3 million in OTTI losses on equity securities during the first nine months of 2011.

### 3. FAIR VALUE MEASUREMENTS

#### *Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

We determined the fair values of certain financial instruments based on the fair value hierarchy. GAAP guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value. Financial assets are classified based upon the lowest level of significant input that is used to determine fair value.

The following are the levels of the fair value hierarchy and a brief description of the type of valuation inputs that are used to establish each level:

**Pricing Level 1** is applied to valuations based on readily available, unadjusted quoted prices in active markets for identical assets. These valuations are based on quoted prices that are readily and regularly available in an active market.

**Pricing Level 2** is applied to valuations based upon quoted prices for similar assets in active markets, quoted prices for identical or similar assets in inactive markets; or valuations based on models where the significant inputs are observable (e.g. interest rates, yield curves, prepayment speeds, default rates, loss severities) or can be corroborated by observable market data.

**Pricing Level 3** is applied to valuations that are derived from techniques in which one or more of the significant inputs are unobservable.

As a part of management's process to determine fair value, we utilize a widely recognized, third-party pricing source to assist our determination of fair values. We have obtained an understanding of the third-party pricing source's valuation methodologies and inputs. The following is a description of the valuation techniques used for financial assets that are measured at fair value, including the general classification of such assets

pursuant to the fair value hierarchy.

**Corporate, Agencies, Treasuries and Municipal Bonds:** The pricing vendor uses a generic model which uses standard inputs, including (listed in order of priority for use), benchmark yields, reported trades, broker/ dealer quotes, issuer spreads, two-sided markets, benchmark securities, market bids/offers and other reference data. The pricing vendor also monitors market indicators, as well as industry and economic events. Further, the model uses Option Adjusted Spread (OAS) and is a multidimensional relational model. All bonds valued using these techniques are classified as Level 2. All corporate, agency, treasury and municipal securities were deemed Level 2.

**Mortgage-backed Securities (MBS)/Collateralized Mortgage Obligations (CMO) and Asset-backed Securities (ABS):** The pricing vendor evaluation methodology includes interest rate movements, new issue data and other pertinent data. Evaluation of the tranches (non-volatile, volatile or credit sensitivity) is based on the pricing vendors' interpretation of accepted modeling and pricing conventions. This information is then used to determine the cash flows for each tranche, benchmark yields, prepayment assumptions and to incorporate collateral performance. To evaluate CMO volatility, an OAS model is used in combination with models that simulate interest rate paths to determine market price information. This process allows the pricing vendor to obtain evaluations of a broad universe of securities in a way that reflects changes in yield curve, index rates, implied volatility, mortgage rates and recent trade activity. MBS/CMO and ABS with corroborated, observable inputs are classified as Level 2. All of our MBS/CMO and ABS are deemed Level 2.

**Common Stock:** Exchange traded equities have readily observable price levels and are classified as Level 1 (fair value based on quoted market prices). All of our common stock holdings are deemed Level 1.

For the Level 2 securities, as a described above, we periodically conduct a review to assess the reasonableness of the fair values provided by our pricing source. Our review consists of a two pronged approach. First, we compare prices provided by our pricing source to those provided by an additional source. Second, we obtain prices from securities brokers and compare them to the prices provided by our pricing source. In both comparisons, when discrepancies are found, we compare our prices to actual reported trade data. Based on this assessment, we determined that the fair values of our Level 2 securities provided by our pricing source are reasonable.

For common stock, we receive prices from the same nationally recognized pricing source. Prices are based on observable inputs in an active market and are therefore disclosed as Level 1. Based on this assessment, we determined that the fair values of our Level 1 securities provided by our pricing source are reasonable.

Due to the relatively short-term nature of cash, short-term investments, accounts receivable and accounts payable, their carrying amounts are reasonable estimates of fair value.

Assets measured at fair value in the accompanying unaudited condensed consolidated interim financial statements on a recurring basis are summarized below:

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| (\$ in 000s)<br>Description                    | As of September 30, 2012<br>Fair Value Measurements Using               |  |  | Total        |
|--|---|--|--|--------------|
|  | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |              |
| Trading securities                             |   |  |  |              |
| Mortgage-backed<br>ABS/CMO*                    | \$  | \$   | 7  | \$ 7         |
| U.S. Government                                |   |  |  |              |
| Total trading securities                       | \$  | \$   | 7  | \$ 7         |
| Available-for-sale securities                  |   |  |  |              |
| U.S. Agencies                                  | \$  | \$   | 19,814   | \$ 19,814    |
| Corporates                                     |   |  | 591,070  | 591,070      |
| Mortgage-backed                                |   |  | 272,275  | 272,275      |
| ABS/CMO*                                       |   |  | 87,701   | 87,701       |
| Non-U.S. govt. & agency                        |   |  | 9,288  | 9,288        |
| U.S. Government                                |   |  | 16,752   | 16,752       |
| States, political subdivisions and<br>revenues |   |  | 436,069  | 436,069      |
| Equities                                       | 402,099   |  |  | 402,099      |
| Total available-for-sale securities            | \$ 402,099  | \$ 1,432,969   | \$   | \$ 1,835,068 |
| Total  | \$ 402,099  | \$ 1,432,976   | \$   | \$ 1,835,075 |

\*Asset-backed & collateralized mortgage obligations

| (\$ in 000s)<br>Description                    | As of December 31, 2011<br>Fair Value Measurements Using                |  |  | Total        |
|--|---|--|--|--------------|
|  | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |              |
| Trading securities                             |   |  |  |              |
| Corporates                                     | \$  | \$   |  | \$           |
| Mortgage-backed<br>ABS/CMO*                    |   |  | 7  | 7            |
| U.S. Government                                |   |  |  |              |
| Total trading securities                       | \$  | \$   | 7  | \$ 7         |
| Available-for-sale securities                  |   |  |  |              |
| U.S. Agencies                                  | \$  | \$   | 113,819  | \$ 113,819   |
| Corporates                                     |   |  | 467,100  | 467,100      |
| Mortgage-backed                                |   |  | 248,986  | 248,986      |
| ABS/CMO*                                       |   |  | 56,953   | 56,953       |
| Non-U.S. govt. & agency                        |   |  | 6,697  | 6,697        |
| U.S. Government                                |   |  | 16,172   | 16,172       |
| States, political subdivisions and<br>revenues |   |  | 236,590  | 236,590      |
| Equities                                       | 388,689   |  |  | 388,689      |
| Total available-for-sale securities            | \$ 388,689  | \$ 1,146,317   | \$   | \$ 1,535,006 |
| Total  | \$ 388,689  | \$ 1,146,324   | \$   | \$ 1,535,013 |

\*Asset-backed & collateralized mortgage obligations

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As noted in the above table, we do not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during

the period. Additionally, there were no securities transferred in or out of levels 1 or 2 during the three-month period and nine-month periods ended September 30, 2012.

#### 4. STOCK BASED COMPENSATION

Our shareholder-approved RLI Corp. Omnibus Stock Plan (omnibus plan) was in place from 2005 to 2010. The omnibus plan provided for grants of up to 1,500,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we have granted 1,228,139 stock options under this plan, including incentive stock options (ISOs) which were adjusted as part of the special dividends in 2011 and 2010.

During the second quarter of 2010, our shareholders approved the RLI Corp. Long-Term Incentive Plan (LTIP), which replaced the omnibus plan. In conjunction with the adoption of the LTIP, effective May 6, 2010, options will no longer be granted under the omnibus plan. Awards under the LTIP may be in the form of restricted stock, stock options (nonqualified only), stock appreciation rights, performance units, as well as other stock-based awards. Eligibility under the LTIP is limited to employees or directors of the company or any affiliate. The granting of awards under the LTIP is solely at the discretion of the board of directors. The total number of shares of common stock available for distribution under the LTIP may not exceed 2,000,000 shares (subject to adjustment for changes in our capitalization). Since 2010, we have granted 797,900 stock options under the LTIP, including 292,900 thus far in 2012.

Under the LTIP, as under the omnibus plan, we grant stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant. Options generally vest and become exercisable ratably over a five-year period. Beginning with the annual grant in May 2009, options granted under both plans have an eight-year life. Prior to that grant, options were granted with a ten-year life. The related compensation expense is recognized over the requisite service period.

In most instances, the requisite service period and vesting period will be the same. For participants who are retirement eligible, defined by the plan as those individuals whose age and years of service equals 75, the requisite service period is deemed to be met and options are immediately expensed on the date of grant. For participants who will become retirement eligible during the vesting period, the requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.

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The following tables summarize option activity for the periods ended September 30, 2012 and 2011:

|   | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in 000 s) |
|---|-------------------------------------|--|---|---|
| Outstanding options at January 1, 2012    | 1,280,866                           | \$ 43.23                                 |   |   |
| Options granted                           | 292,900                             | \$ 68.46                                 |   |   |
| Options exercised                         | (63,721)                            | \$ 40.29                                 |   | \$ 1,966                                      |
| Options canceled/forfeited                | (3,120)                             | \$ 45.84                                 |   |   |
| Outstanding options at September 30, 2012 | 1,506,925                           | \$ 48.26                                 | 5.32  | \$ 28,385                                     |
| Exercisable options at September 30, 2012 | 738,945                             | \$ 40.78                                 | 4.33  | \$ 19,125                                     |

|   | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in 000 s) |
|---|-------------------------------------|--|---|---|
| Outstanding options at January 1, 2011    | 1,524,982                           | \$ 41.32                                 |   |   |
| Options granted                           | 254,450                             | \$ 58.97                                 |   |   |
| Options exercised                         | (422,457)                           | \$ 33.34                                 |   | \$ 11,220                                     |
| Options canceled/forfeited                | (24,350)                            | \$ 45.84                                 |   |   |
| Outstanding options at September 30, 2011 | 1,332,625                           | \$ 47.14                                 | 5.96  | \$ 21,910                                     |
| Exercisable options at September 30, 2011 | 628,725                             | \$ 43.62                                 | 5.07  | \$ 12,551                                     |

The majority of our options are granted annually at our regular board meeting in May. Thus far in 2012, 292,900 options were granted with an average exercise price of \$68.46 and an average fair value of \$13.13. We recognized \$0.9 million of expense in the third quarter of 2012, and \$2.7 million in the first nine months of 2012, related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.3 million in the third quarter of 2012, and \$0.9 million in the first nine months of 2012, related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.7 million, which will be recognized over the remainder of the vesting period. Comparatively, we recognized \$1.0 million of expense in the third quarter of 2011, and \$2.6 million in the first nine months of 2011. We recorded a tax benefit of \$0.3 million in the third quarter of 2011, and \$0.9 million in the first nine months of 2011, related to this compensation expense.



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

|                                       | <b>2012</b> | <b>2011</b> |
|---------------------------------------|-------------|-------------|
| Weighted-average fair value of grants | \$ 13.13    | \$ 12.97    |
| Risk-free interest rates              | 0.90%       | 2.22%       |
| Dividend yield                        | 1.93%       | 1.89%       |
| Expected volatility                   | 25.64%      | 25.67%      |
| Expected option life                  | 5.39 years  | 5.50 years  |

The risk-free rate is determined based on U.S. treasury yields that most closely approximate the option's expected life. The dividend yield is calculated based on the average annualized dividends paid during the most recent five-year period. It excludes the special dividends paid in the fourth quarters of 2011 and 2010. The expected volatility is calculated based on the mean reversion of RLI's stock. Prior to the second quarter of 2009, it was calculated by computing the weighted average of the most recent one-year volatility, the most recent volatility based on expected life and the median of the rolling volatilities based on the expected life of RLI stock. The expected option life is determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant.

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

SEGMENT DATA (in thousands)

|  | For the Three-Month Periods<br>Ended September 30,<br>REVENUES |            | For the Nine-Month Periods<br>Ended September 30,<br>REVENUES |            |
|--|--|------------|---|------------|
|  | 2012   | 2011       | 2012  | 2011       |
| Casualty                                       | \$ 68,194  | \$ 60,626  | \$ 197,409  | \$ 173,937 |
| Property                                       | 54,741   | 59,226     | 151,581   | 148,015    |
| Surety   | 27,008   | 26,700     | 79,817  | 71,477     |
| Net premiums earned                            | \$ 149,943   | \$ 146,552 | \$ 428,807  | \$ 393,429 |
| Net investment income                          | 14,221   | 15,954     | 44,340  | 47,437     |
| Net realized gains (losses)                    | 5,481  | (177)      | 16,233  | 14,345     |
| Total consolidated revenue                     | \$ 169,645   | \$ 162,329 | \$ 489,380  | \$ 455,211 |
|  | NET EARNINGS   |            | NET EARNINGS  |            |
|  | 2012   | 2011       | 2012  | 2011       |
| Casualty                                       | \$ 10,806  | \$ 22,265  | \$ 22,409   | \$ 53,645  |
| Property                                       | (310)  | (1,813)    | 11,317  | 15,653     |
| Surety   | 8,034  | 1,072      | 21,368  | 15,263     |
| Net underwriting income                        | \$ 18,530  | \$ 21,524  | \$ 55,094   | \$ 84,561  |
| Net investment income                          | 14,221   | 15,954     | 44,340  | 47,437     |
| Net realized gains (losses)                    | 5,481  | (177)      | 16,233  | 14,345     |
| General corporate expense and interest on debt | (3,611)  | (3,107)    | (10,438)  | (10,100)   |
| Equity in earnings of unconsolidated investee  | 1,859  | 713        | 8,928   | 7,215      |
| Total earnings before income taxes             | \$ 36,480  | \$ 34,907  | \$ 114,157  | \$ 143,458 |
| Income tax expense                             | 11,017   | 10,938     | 35,908  | 46,791     |
| Total net earnings                             | \$ 25,463  | \$ 23,969  | \$ 78,249   | \$ 96,667  |

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

| (in thousands)                   | For the Three-Month Periods<br>Ended September 30, |                   | For the Nine-Month Periods<br>Ended September 30, |                   |
|----------------------------------|--|-------------------|---|-------------------|
|                                  | 2012   | 2011              | 2012  | 2011              |
| <b>Casualty</b>                  |  |                   |   |                   |
| General liability                | \$ 21,556  | \$ 20,693         | \$ 63,449   | \$ 63,817         |
| Commercial and personal umbrella | 17,430   | 15,825            | 50,337  | 47,110            |
| Commercial transportation        | 8,583  | 8,326             | 25,252  | 25,843            |
| P&C package business             | 7,479  | 6,126             | 21,334  | 10,235            |
| Executive products               | 3,914  | 3,716             | 11,666  | 10,901            |
| Professional services            | 7,386  | 3,655             | 19,704  | 8,416             |
| Specialty programs               | 540  | 948               | 1,878   | 3,377             |
| Other                            | 1,306  | 1,337             | 3,789   | 4,238             |
| <b>Total</b>                     | <b>\$ 68,194</b>                                   | <b>\$ 60,626</b>  | <b>\$ 197,409</b>                                 | <b>\$ 173,937</b> |
| <b>Property</b>                  |  |                   |   |                   |
| Commercial property              | \$ 18,640  | \$ 20,295         | \$ 55,285   | \$ 60,894         |
| Marine                           | 14,026   | 13,544            | 44,591  | 38,865            |
| Crop reinsurance                 | 9,876  | 14,873            | 15,992  | 22,207            |
| Property reinsurance             | 6,826  | 6,087             | 20,193  | 14,456            |
| Other property                   | 5,373  | 4,427             | 15,520  | 11,593            |
| <b>Total</b>                     | <b>\$ 54,741</b>                                   | <b>\$ 59,226</b>  | <b>\$ 151,581</b>                                 | <b>\$ 148,015</b> |
| <b>Surety</b>                    |  |                   |   |                   |
| Miscellaneous                    | \$ 10,026  | \$ 9,923          | \$ 29,600   | \$ 24,947         |
| Contract                         | 6,835  | 6,901             | 19,507  | 17,274            |
| Commercial                       | 5,574  | 5,387             | 16,536  | 15,770            |
| Oil and Gas                      | 4,573  | 4,489             | 14,174  | 13,486            |
| <b>Total</b>                     | <b>\$ 27,008</b>                                   | <b>\$ 26,700</b>  | <b>\$ 79,817</b>                                  | <b>\$ 71,477</b>  |
| <b>Grand Total</b>               | <b>\$ 149,943</b>                                  | <b>\$ 146,552</b> | <b>\$ 428,807</b>                                 | <b>\$ 393,429</b> |

Reclassifications have been made between specific product types in our casualty segment. Effective December 2011, revenues from our Miscellaneous Professional Liability and Cyber Liability lines of business were reclassified to be reported within our Professional Services products. Prior to the reclassification the revenues from these products were reported in Executive Products. All comparative periods have been adjusted to reflect these changes.

## 6. ACQUISITION

On April 28, 2011, we acquired Contractors Bonding and Insurance Company (CBIC) through an acquisition of its holding company, Data and Staff Service Co., for \$135.9 million in cash. Prior to the acquisition, CBIC was a privately held, Seattle-based insurance company specializing in surety bonds and related niche property and casualty insurance products. The company serves over 30,000 contractors and over 4,000 insurance agents and brokers nationwide. CBIC operates 12 regional branch offices and is a leading writer of contractor license bonds in the Northwest.

During the second quarter of 2011, we began our integration of CBIC operations and personnel into the normal operations of our company and our fair value analysis on CBIC's opening balance sheet. The unaudited condensed consolidated interim financial statements include CBIC's results of operations for the nine-month period ended September 30, 2012 and its assets and liabilities as of September 30, 2012. Comparative period information includes results of operations for the five-month period subsequent to acquisition and assets and liabilities as of September 30, 2011.

Goodwill of \$20.4 million, representing the difference between the purchase consideration and the fair value of assets acquired less liabilities assumed, was recorded. In addition, \$14.5 million of separately identifiable intangible assets resulting from the valuations of trade name, insurance licenses, acquired software and agency-related relationships have been recognized (\$13.2 million net of related amortization as of September 30, 2012). The valuation of insurance policies in force, including the value of business acquired (VOBA), was \$10.8 million at acquisition. VOBA is included within deferred policy acquisition costs on our consolidated balance sheet. This asset is amortized as the corresponding unearned premium (UEP) acquired (\$29.5 million) is earned as revenue. As of September 30, 2012, 95 percent of the UEP acquired had been earned as revenue. As a result, a similar percentage of VOBA was amortized to expense. At September 30, 2012, \$1.5 million of the UEP acquired remained, as does \$0.8 million of VOBA.

During the third quarter of 2012, CBIC contributed \$14.4 million of gross premiums written. Premiums of \$8.4 million impacted the casualty segment with the remaining \$6.0 million attributable to the surety segment. CBIC contributed pretax earnings of \$5.1 million, which included underwriting income of \$4.1 million and net investment income of \$1.0 million. Results included favorable reserve development on prior years loss reserves which totaled \$4.2 million. For the nine months ended September 30, 2012, CBIC generated an underwriting income of \$8.9 million and net investment income of \$3.1 million.

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

**SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995:** This discussion and analysis may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Various risk factors that could affect future results are listed in our filings with the Securities and Exchange Commission, including the Annual Report on Form 10-K for the year ended December 31, 2011.

**OVERVIEW**

We underwrite selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group (the Group). We conduct operations principally through four insurance companies. RLI Insurance Company, our principal subsidiary, writes multiple lines of 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 (RIC), a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines of insurance on an admitted basis in 48 states and the District of Columbia. RIC also has authority to write fidelity and surety in North Carolina. Contractors Bonding and Insurance Company (CBIC), a subsidiary of RLI Insurance Company, has authority to write multiple lines of insurance on an admitted basis in all 50 states and the District of Columbia. We are an Illinois corporation that was organized in 1965.

As a niche company, we offer specialty insurance coverages designed to meet specific insurance needs of targeted insured groups and underwrite for certain markets that are underserved by the insurance and reinsurance 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 for customers with hard-to-place risks. When we underwrite within the surplus lines market, we are selective in the lines 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, our underwriters determine whether it would be a viable product based on our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all market conditions and we achieved this for 16 consecutive years, averaging an 87.0 combined ratio over that period of time. This foundation drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio and long-term appreciation in our equity portfolio. Our investment

strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly-rated, diversified, liquid investment-grade securities. Consistent underwriting income allows a portion of our shareholders' equity to be invested in equity securities. Our equity portfolio consists of a core stock portfolio weighted toward dividend-paying stocks, as well as exchange traded funds (ETFs). Our minority equity ownership in Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality sunglasses, has also enhanced overall returns. We have a diversified investment portfolio and balance our investment credit risk to minimize aggregate credit exposure. Despite fluctuations of realized and unrealized gains and losses in the equity portfolio, our investment in equity securities, as part of a long-term asset allocation strategy, has contributed significantly to our historic growth in book value.

We measure the results of our insurance operations by monitoring certain measures of growth and profitability across three distinct business segments: casualty, property and surety. Growth is measured in terms of gross premiums written, and profitability is analyzed through combined ratios, which are further subdivided into their respective loss and expense components. The combined ratios represent the income generated from our underwriting segments.

The property and casualty insurance business is cyclical and influenced by many factors, including price competition, economic conditions, natural or man-made disasters (for example, earthquakes, hurricanes, and terrorism), interest rates, state regulations, court decisions and changes in the law.

One of the unique and challenging features of the property and casualty insurance business is that coverages must be priced before costs have fully developed, because premiums are charged before claims are incurred. This requires that liabilities be estimated and recorded in recognition of future loss and settlement obligations. Due to the inherent uncertainty in estimating these liabilities, there can be no assurance that actual liabilities will not be more or less than recorded amounts; if actual liabilities differ from recorded amounts, there will be an adverse or favorable effect on net earnings. In evaluating the objective performance measures previously mentioned, it is important to consider the following individual characteristics of each major insurance segment.

The casualty portion of our business consists largely of general liability, personal umbrella, transportation, executive products, commercial umbrella, multi-peril program and package business and other specialty coverages, such as our professional liability for design professionals. We also offer fidelity and crime coverage for commercial insureds and select financial institutions. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty segment is also subject to inflation risk and may be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

Our property segment is comprised primarily of commercial fire, earthquake, difference in conditions, marine, facultative and treaty reinsurance, including crop, and, in the state of Hawaii, select personal lines policies. While our marine and facultative reinsurance coverages are predominantly

domestic risks, these portfolios do contain a relatively small portion of foreign exposures. Property insurance and reinsurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coast, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by minimizing the total policy limits written in a particular region, purchasing reinsurance and through extensive use of computer-assisted modeling techniques. These techniques provide estimates that help us carefully manage the concentration of risks exposed to catastrophic events. Our assumed multi-peril crop and hail treaty reinsurance business covers revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects and disease. Significant aggregation of these losses is mitigated by the U.S. Federal Government reinsurance program that provides stop loss protection inuring to our benefit.

The surety segment specializes in writing small-to-large commercial and contract surety coverages, as well as those for the energy, petrochemical and refining industries. We offer miscellaneous bonds, including license and permit, notary and court bonds. Often, our surety coverages involve a statutory requirement for bonds. While these bonds maintained a relatively low loss ratio, losses may fluctuate due to adverse economic conditions affecting the financial viability of our insureds. The contract surety product guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic conditions causing the deterioration of a contractor's financial condition. This line has historically produced marginally higher loss ratios than other surety lines during economic downturns.

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

#### ***GAAP and non-GAAP Financial Performance Metrics***

Throughout this quarterly report, we present our operations in the way we believe will be most meaningful, useful, and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP presentation of net income, we show certain statutory reporting information and other non-GAAP financial measures that we believe are valuable in managing our business and drawing comparisons to our peers. These measures are underwriting income, combined ratios and net unpaid loss and settlement expenses.

Following is a list of non-GAAP measures found throughout this report with their definitions, relationships to GAAP measures and explanations of their importance to our operations.

*Underwriting Income*

Underwriting income or profit represents one measure of the pretax profitability of our insurance operations and is derived by subtracting losses and settlement expenses, policy acquisition costs and insurance operating expenses from net premiums earned. Each of these captions is presented in the statements of earnings, but not subtotaled. However, this information is available in total and by segment in note 11 to the consolidated financial statements, regarding operating segment information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains/losses on investments, general corporate expenses, debt costs and unconsolidated investee earnings.

*Combined ratio*

This ratio is a common industry measure of profitability for any underwriting operation, and is calculated in two components. First, the loss ratio is losses and settlement expenses divided by net premiums earned. The second component, the expense ratio, reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. All items included in these components of the combined ratio are presented in our GAAP financial statements. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss. For example, a combined ratio of 85 implies that for every \$100 of premium we earn, we record \$15 of underwriting income.

*Net Unpaid Loss and Settlement Expenses*

Unpaid losses and settlement expenses, as shown in the liabilities section of our balance sheets, represents the total obligations to claimants for both estimates of known claims and estimates for incurred but not reported (IBNR) claims. The related asset item, reinsurance balances recoverable on unpaid losses and settlement expense, is the estimate of known claims and estimates of IBNR that we expect to recover from reinsurers. The net of these two items is generally referred to as net unpaid loss and settlement expenses and is commonly used in our disclosures regarding the process of establishing these various estimated amounts.

**Critical Accounting Policies**

In preparing the unaudited condensed consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates.

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





## *Unpaid Losses and Settlement Expenses*

### *Overview*

Loss and loss adjustment expense (LAE) reserves represent our best estimate of ultimate payments 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, 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 from 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 significantly different amount than currently reserved – favorable or 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 it. The estimate reflects all of the current information available regarding the claim, the informed judgment of our professional claim personnel regarding the nature and value of the specific type of claim and our reserving practices. During the life cycle of a particular claim, as more information becomes available, we may 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 closed, but may reopen and require future payment.

Our IBNR reserving process involves three steps: (1) an initial IBNR generation process that is prospective in nature; (2) a loss and LAE reserve estimation process that occurs retrospectively; and (3) 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 September 30, 2012, make a reasonable provision to meet our future obligations.

#### *Initial IBNR Generation Process*

Initial carried IBNR reserves are determined through a reserve generation process. The intent of this process is to establish an initial total reserve

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

For most property products, we use an alternative method of determining an appropriate provision for initial IBNR. Since this segment is characterized by a shorter period of time between claim occurrence and claim settlement, the IBNR reserve is determined by an IBNR percentage applied to premium earned. The IBNR percentage is determined based on historical reporting patterns and is updated periodically. In addition, for assumed property reinsurance, consideration is given to data compiled for a sizable sample of reinsurers. No deductions for paid or case reserves are made. This alternative method of determining initial IBNR allows incurred losses and ALAE to react more rapidly to the actual emergence and is more appropriate for our property products where final claim resolution occurs over a shorter period of time. For assumed crop reinsurance we rely on information provided by the ceding company.

Our crop reinsurance business is unique and is subject to an inherently higher degree of estimation risk during interim periods. As a result, the interim reports and professional judgments of our ceding company's actuaries and crop business experts provide important information which assists us in estimating our carried reserves.

We do not reserve for natural or man-made catastrophes until an event has occurred. Shortly after such occurrence, we review insured locations exposed to the event, catastrophe model loss estimates based on our own exposures and industry loss estimates of the event. We also consider our knowledge of frequency and severity from early claim reports to determine an appropriate reserve for the catastrophe. These reserves are reviewed frequently to consider actual losses reported and appropriate changes to our estimates are made to reflect the new information.

The initial loss and ALAE ratios that are applied to earned premium are reviewed at least semi-annually. Prospective estimates are made based on historical loss experience adjusted for exposure mix, price change and loss cost trends. The initial loss and ALAE ratios also reflect a provision for estimation risk. We consider estimation risk by product and coverage within product, if applicable. A product with greater overall volatility and uncertainty has greater estimation risk. Characteristics of products or coverages with higher estimation risk include, but are not limited to, the following:

- Significant changes in underlying policy terms and conditions,
- A new business or one experiencing significant growth and/or high turnover,
- Small volume or lacking internal data requiring significant utilization of external data,
- Unique reinsurance features including those with aggregate stop-loss, reinstatement clauses, commutation provisions, or clash protection,
- Longer emergence patterns with exposures to latent unforeseen mass tort,

- Assumed reinsurance businesses where there is an extended reporting lag and/or a heavier utilization of ceding company data and claims and product expertise,
- High severity and/or low frequency,
- Operational processes undergoing significant change, and/or
- High sensitivity to significant swings in loss trends or economic change.

The historical and prospective loss and ALAE estimates, along with the risks listed, are the basis for determining our initial and subsequent carried reserves. Adjustments in the initial loss ratio by product and segment are made where necessary and reflect updated assumptions regarding loss experience, loss trends, price changes and prevailing risk factors. The LRC makes all final decisions regarding changes in the initial loss and ALAE ratios.

#### *Loss and LAE Reserve Estimation Process*

A full analysis of our loss reserves takes place at least semi-annually. The purpose of this analysis is to provide validation of our carried loss reserves. Estimates of the expected value of the unpaid loss and LAE are derived using actuarial methodologies. These estimates are then compared to the carried loss reserves to determine the appropriateness of the current reserve balance.

The process of estimating ultimate payment for claims and claim expenses begins with the collection and analysis of current and historical claim data. Data on individual reported claims, including paid amounts and individual claim adjuster estimates, are grouped by common characteristics. There is judgment involved in this grouping. Considerations when grouping data include the volume of the data available, the credibility of the data available, the homogeneity of the risks in each cohort and both settlement and payment pattern consistency. We use this data to determine historical claim reporting and payment patterns which are used in the analysis of ultimate claim liabilities. For portions of the business without sufficiently large numbers of policies or that have not accumulated sufficient historical statistics, our own data is supplemented with external or industry average data as available and when appropriate. For our newer products such as crop reinsurance, as well as for executive products, professional services and marine, we utilize external data extensively.

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

We use historical development patterns, expected loss ratios and standard actuarial methods to derive an estimate of the ultimate level of loss and LAE payments necessary to settle all the claims occurring as of the end of the evaluation period. Once an estimate of the ultimate level of claim payments



has been derived, the amount of paid loss and LAE and case reserve through the evaluation date is subtracted to reveal the resulting IBNR.

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

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

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

- Loss payment patterns,
- Loss reporting patterns,
- Frequency and severity trends,
- Underlying policy terms and conditions,
- Business or exposure mix,
- Operational or internal processes affecting the timing of loss and LAE transactions,
- Regulatory and legal environment, and/or
- Economic environment.

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

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

Given the substantial impact of the reserve estimates on our financial statements, we subject the reserving process to significant diagnostic testing and reasonability checks. In addition, there are data validity checks and balances in our front-end processes. Data anomalies are researched and explained to reach a comfort level with the data and results. Leading indicators such as actual versus expected emergence and other diagnostics are also incorporated into the reserving processes.



*Determination of Our Best Estimate*

Upon completion of our full loss and LAE estimation analysis, the results are discussed with the LRC. As part of this discussion, the analysis supporting an actuarial central estimate of the IBNR loss reserve by product is reviewed. The actuaries also present explanations supporting any changes to the underlying assumptions used to calculate the indicated central estimate. A review of the resulting variance between the indicated reserves and the carried reserves determined from the initial IBNR generation process takes place. Quarterly, we also consider the most recent actual loss emergence compared to the expected loss emergence derived using the last full loss and ALAE analyses. Our actuaries make a recommendation to management in regards to booked reserves that reflect their analytical assessment and view of estimation risk. After discussion of these analyses and all relevant risk factors, the LRC determines whether the reserve balances require adjustment. Resulting reserve balances have always fallen within our actuaries' reasonable range of estimates.

As a predominantly excess and surplus lines and specialty insurer servicing niche markets, we believe there are several reasons to carry on an overall basis reserves above the actuarial central estimate. We believe we are subject to above-average variation in estimates and that this variation is not symmetrical around the actuarial central estimate.

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

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

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

risks materialize above the amount we considered when booking our initial loss reserves. In this case, unfavorable loss development is likely to occur over subsequent accounting periods.

Our best estimate of loss and LAE reserves may change as a result of a revision in the actuarial central estimate, the actuary's certainty in the estimates and processes and our overall view of the underlying risks. From time to time, we benchmark our reserving policies and procedures and refine them by adopting industry best practices where appropriate. A detailed, ground-up analysis of the actuarial estimation risks associated with each of our products and segments, including an assessment of industry information, is performed annually. This information is used when determining management's best estimate of booked reserves.

Loss reserve estimates are subject to a high degree of variability due to the inherent uncertainty of ultimate settlement values. Periodic adjustments to these estimates will likely occur as the actual loss emergence reveals itself over time. We believe our loss reserving processes reflect accepted actuarial practices and our methodologies result in a reasonable provision for reserves as of September 30, 2012.

#### ***Investment Valuation and OTTI***

Throughout each year, we and our investment managers buy and sell securities to achieve investment objectives in accordance with investment policies established and monitored by our board of directors and executive officers.

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

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

We determined the fair value of certain financial instruments based on the fair value hierarchy. GAAP guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value.

We regularly evaluate our fixed income and equity securities using both quantitative and qualitative criteria to determine impairment losses for other-than-temporary declines in the fair value of the investments. The following are some of the key factors we consider for determining if a security is other-than-temporarily impaired:

- The length of time and the extent to which the fair value has been less than cost,
- The probability of significant adverse changes to the cash flows on a fixed income investment,



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- The occurrence of a discrete credit event resulting in the issuer defaulting on a material obligation, the issuer seeking protection from creditors under the bankruptcy laws, or the issuer proposing a voluntary reorganization under which creditors are asked to exchange their claims for cash or securities having a fair value substantially lower than par value of their claims,
- The probability that we will recover the entire amortized cost basis of our fixed income securities prior to maturity, or
- For our equity securities, our expectation of recovery to cost within a reasonable period of time.

Quantitative criteria considered during this process include, but are not limited to: the degree and duration of current fair value as compared to the cost (amortized, in certain cases) of the security, degree and duration of the security's fair value being below cost and, for fixed maturities, whether the issuer is in compliance with the terms and covenants of the security. Qualitative criteria include the credit quality, current economic conditions, the anticipated speed of cost recovery, the financial health of and specific prospects for the issuer, as well as our absence of intent to sell or requirement to sell fixed income securities prior to maturity. In addition, we consider price declines of securities in our OTTI analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

Key factors that we consider in the evaluation of credit quality include:

- Changes in technology that may impair the earnings potential of the investment,
- The discontinuance of a segment of the business that may affect the future earnings potential,
- Reduction or elimination of dividends,
- Specific concerns related to the issuer's industry or geographic area of operation,
- Significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
- Downgrade in credit quality by a major rating agency.

For mortgage-backed securities and asset-backed securities that have significant unrealized loss positions and major rating agency downgrades, credit impairment is assessed using a cash flow model that estimates likely payments using security-specific collateral and transaction structure. All of our mortgage-backed and asset-backed securities remain AAA-rated by the major rating agencies and the fair value is not significantly less than amortized cost. In addition, the current cash flow assumptions are the same assumptions used at purchase which reflects no credit issues at this time.

Under current accounting standards, an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered by circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security's amortized cost and its fair



value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.

Part of our evaluation of whether particular securities are other-than-temporarily impaired involves assessing whether we have both the intent and ability to continue to hold equity securities in an unrealized loss position. For fixed income securities, we consider our intent to sell a security (which is determined on a security-by-security basis) and whether it is more-likely-than-not we will be required to sell the security before the recovery of our amortized cost basis. Significant changes in these factors could result in a charge to net earnings for impairment losses. Impairment losses result in a reduction of the underlying investment's cost basis.

#### ***Recoverability of Reinsurance Balances***

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, rather than being netted with the related liabilities, since reinsurance does not relieve us of our liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. Additionally, the same uncertainties associated with estimating unpaid losses and settlement expenses impact the estimates for the ceded portion of such liabilities. We continually monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements, Securities and Exchange Commission filings for those reinsurers that are publicly traded, A.M. Best and S&P rating developments and insurance industry developments that may impact the financial condition of our reinsurers. In addition, we subject our reinsurance recoverables to detailed recoverable tests, including one based on average default by S&P rating. Based upon our review and testing, our policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that we may be unable to recover. Further discussion of our reinsurance balances recoverable can be found in note 5 to the financial statements included in our 2011 Annual Report on Form 10-K.

#### ***Deferred Policy Acquisition Costs***

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

premiums written. This deferral methodology applies to both gross and ceded premiums and acquisition costs. See Note 1B for discussion of our retrospective application of a new accounting standard which impacts accounting for costs associated with acquiring insurance policies.

### *Deferred Taxes*

We record net deferred tax assets to the extent temporary differences representing future deductible items exceed future taxable items. A significant amount of our deferred tax assets relate to expected future tax deductions arising from claim reserves and future taxable income related to changes in our unearned premium.

Periodically, management reviews our deferred tax positions to determine if it is more-likely-than-not that the assets will be realized. These reviews include, among other things, the nature and amount of the taxable income and expense items, the expected timing of when assets will be used or liabilities will be required to be reported and the reliability of historical profitability of businesses expected to provide future earnings. Furthermore, management considers tax-planning strategies it can use to increase the likelihood that the tax assets will be realized. If after conducting the periodic review management determines that the realization of the tax asset does not meet the more-likely-than-not criteria, an offsetting valuation allowance is recorded, thereby reducing net earnings and the deferred tax asset in that period. In addition, management must make estimates of the tax rates expected to apply in the periods in which future taxable items are realized. Such estimates include determinations and judgments as to the expected manner in which certain temporary differences, including deferred amounts related to our equity method investment, will be recovered. These estimates enter into the determination of the applicable tax rates and are subject to change based on the circumstances.

We consider uncertainties in income taxes and recognize those in our financial statements as required. As it relates to uncertainties in income taxes, our unrecognized tax benefits, including interest and penalty accruals, are not considered material to the unaudited condensed consolidated interim financial statements. Also, no tax uncertainties are expected to result in significant increases or decreases to unrecognized tax benefits within the next 12-month period. Penalties and interest related to income tax uncertainties, should they occur, would be included in tax expense.

### **NINE MONTHS ENDED SEPTEMBER 30, 2012, COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2011**

Consolidated revenues, as displayed in the table that follows, totaled \$489.4 million for the first nine months of 2012 compared to \$455.2 million for the same period in 2011.

|   | For the Nine-Month Periods<br>Ended September 30, |            |
|---|---|------------|
|   | 2012  | 2011       |
| <b>Consolidated revenues</b> (in thousands) |   |            |
| Net premiums earned                         | \$ 428,807  | \$ 393,429 |
| Net investment income                       | 44,340  | 47,437     |
| Net realized investment gains               | 16,233  | 14,345     |
| Total consolidated revenue                  | \$ 489,380  | \$ 455,211 |

Consolidated revenue for the first nine months of 2012 increased \$34.2 million, or 8%, from the same period in 2011, as net premiums earned for the Group increased 9% from 2011 levels. All three segments showed growth from 2011 primarily as a result of new product initiatives and positive pricing trends in the market. The acquisition of CBIC added \$37.3 million in net premiums earned in the first nine months of 2012, an increase of \$17.4 million from the same period in 2011. CBIC contributed nine months of revenue in 2012 compared to the five months subsequent to acquisition in 2011. Net investment income declined 7% to \$44.3 million on lower reinvestment rates and a higher allocation to tax-exempt municipals which have lower nominal yields than taxable alternatives. We realized net investment gains of \$16.2 million in the first nine months of 2012, compared to \$14.3 million during the same period of 2011. Realized gains for 2012 include a second quarter \$1.2 million OTTI write-down on a portion of the equity portfolio.

Net after-tax earnings for the first nine months of 2012 totaled \$78.2 million, \$3.64 per diluted share, compared to \$96.7 million, \$4.53 per diluted share for the same period in 2011. Both periods benefited from underwriting income that was bolstered by favorable reserve development. In 2012, favorable development on prior years loss and hurricane reserves resulted in additional pretax earnings of \$58.4 million. Partially offsetting the favorable development was \$15.0 million in spring storm losses, and \$5.0 million in losses from Hurricane Isaac. In addition, drought conditions across the United States resulted in adverse loss experience on the 2012 crop reinsurance year. From a comparative standpoint, results for 2011 included \$92.0 million of favorable development on prior years loss reserves, which was partially offset by \$13.0 million in spring storm losses, \$6.5 million in losses on Hurricane Irene, and \$1.0 million in reserves that were established for the losses associated with the Japan earthquake and tsunami, primarily on marine coverages. Results for 2011 were also impacted by \$4.8 million of adverse current year loss experience on contract surety and marine coverages. Bonus and profit sharing-related expenses associated with these specific items totaled \$4.8 million in 2012 and \$8.2 million in 2011. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance, principally operating earnings and return on capital.

During the first nine months of 2012, equity in earnings of unconsolidated investee totaled \$8.9 million from Maui Jim, Inc. (Maui Jim). This result was \$1.7 million higher than results for the same period last year, due to increased sales and improved foreign exchange results.

Results for the first nine months of 2012 included pretax net realized investment gains of \$16.2 million, compared to \$14.3 million for the same period last year. Net gains for 2012 include losses associated with the



impairments of a long-lived asset and second quarter other-than-temporary impairment losses totaling \$4.8 million.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (loss) (primarily the change in unrealized gains/losses, net of tax), totaled \$116.0 million, \$5.39 per diluted share, for the first nine months of 2012, compared to \$90.3 million, \$4.24 per diluted share, for the same period in 2011. Unrealized gains, net of tax, for the first nine months of 2012 were \$37.7 million, compared to unrealized losses, net of tax, of \$6.3 million for the same period in 2011. Current asset allocation strategies have focused on high quality fixed income securities within our target duration.

## RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group increased 12% to \$601.8 million for the first nine months of 2012. All three segments posted growth in premium writings, driven by expansion efforts and new product initiatives coupled with improved pricing on select lines. Primary and reinsurance pricing continue to exhibit signs of stabilizing with increased pricing on select lines. Underwriting income for the Group decreased to \$55.1 million for the first nine months of 2012 compared to \$84.6 million in 2011. Both periods were impacted by similar amounts of hurricane and spring storm losses. The result for 2012, however, included a reduced benefit for favorable development on prior year loss and hurricane reserves. Favorable development for the first nine months of 2012 totaled \$58.4 million, compared to \$92.0 million for the same period in 2011. The GAAP combined ratio totaled 87.1 in 2012, compared to 78.5 in 2011. The Group's loss ratio increased to 45.1, from 36.1, while the Group's expense ratio decreased to 42.0 from 42.4. Bonus and profit sharing-related expenses related to the favorable development totaled \$4.8 million in 2012, down from \$8.2 million in 2011.

|  | For the Nine-Month Periods<br>Ended September 30, |            |
|--|---|------------|
|  | 2012  | 2011       |
| <b>Gross premiums written</b> (in thousands) |   |            |
| Casualty                                     | \$ 288,652  | \$ 239,083 |
| Property                                     | 226,382   | 218,555    |
| Surety                                       | 86,750  | 80,203     |
| Total  | \$ 601,784  | \$ 537,841 |
| <b>Underwriting income</b> (in thousands)    |   |            |
| Casualty                                     | \$ 22,409   | \$ 53,645  |
| Property                                     | 11,317  | 15,653     |
| Surety                                       | 21,368  | 15,263     |
| Total  | \$ 55,094   | \$ 84,561  |
| <b>Combined ratio</b>                        |   |            |
| Casualty                                     | 88.6  | 69.2       |
| Property                                     | 92.6  | 89.4       |
| Surety                                       | 73.2  | 78.7       |
| Total  | 87.1  | 78.5       |

### *Casualty*

Gross premiums written for the casualty segment totaled \$288.7 million for the first nine months of 2012, an increase of \$49.6 million, or 21%, from the same period last year, due to the acquisition of CBIC, growth in existing products and moderate price improvements. CBIC contributed \$26.2 million of gross premiums written to the casualty segment. Growth within the segment continues despite an ongoing soft pricing environment and weak economy, though these obstacles exist to lesser degree than in recent quarters. General liability, our largest casualty product, recorded gross premiums written of \$71.0 million, an increase of \$3.1 million, or 5%, from the same period last year. Commercial umbrella recorded gross premiums written of \$39.6 million, an increase of \$20.3 million, or 105%, from the same period last year, as our existing general liability policies have generated increased opportunities to write umbrella coverages. Our professional services product, which was launched in 2009 to provide professional liability coverage for design professionals and which now offers additional coverages to its target market, posted \$30.7 million in gross premiums written during the first nine months of 2012, up \$7.5 million, or 33%, from the same period last year. In addition, our executive products group contributed \$30.4 million of gross premiums written, an increase of 3% from the same period last year and transportation totaled \$36.1 million for 2012, an increase of 12%.

In total, the casualty segment recorded underwriting income of \$22.4 million, compared to \$53.6 million for the same period last year. Both periods included favorable development on prior years' loss reserves. Products with favorable prior year development in 2012 included general liability, commercial umbrella, personal umbrella, and specialty programs. Due to positive emergence, during the first nine months of 2012, we released reserves, improving the segment's underwriting results by \$35.9 million. From an accident year standpoint, the majority of the favorable development occurred on more recent accident years (2007-2011). Loss trends on shorter-tail casualty products, such as personal umbrella and specialty programs, remained favorable, and general liability has also continued to trend favorably. From a comparative standpoint, results for 2011 included \$68.9 million of favorable loss experience on prior accident years, primarily for general liability, commercial and personal umbrella, transportation, specialty programs and executive products.

Overall, the combined ratio for the casualty segment was 88.6 for 2012 compared to 69.2 in 2011. The segment's loss ratio was 51.7 in 2012 compared to 30.9 in 2011, driven by product mix and the lower amount of favorable development on prior accident years' reserves. The expense ratio for the casualty segment was 36.9 for the first nine months of 2012 compared to 38.3 for the same period of 2011. This decrease is due largely to lower bonus and profit sharing expenses associated with the reduced favorable reserve development in 2012.

### *Property*

Gross premiums written for the Group's property segment totaled \$226.4 million for the first nine months of 2012, an increase of \$7.8 million, or 4%, from the same period last year. The increase is attributable to recent product launches as well as growth in some of our mature products. The property reinsurance program contributed \$29.6 million in gross premiums written in the

period, up 9%, or \$2.5 million, from the same period last year. We also saw slight growth in our crop reinsurance product, which increased 1% from the same period last year to \$35.5 million in gross premiums written for the year. However, on a net basis, crop business decreased by \$10.5 million, or 30%, as our share in the existing agreement decreased from a 6% share to a 4% share, and an additional reinsurance contract resulted in us retroceding 67% of the premiums and losses on the 2012 crop reinsurance year to another reinsurance partner. One of our more mature products, marine, also grew in the first nine months of 2012. Gross premiums written for our marine division totaled \$48.9 million for the first nine months of 2012, an increase of \$1.8 million, or 4%, from the same period in 2011 due largely to growth in premiums from our inland marine product. Additional growth in the first nine months of 2012 was attributable to our fire and difference-in-conditions (DIC) products, which increased gross premiums written by \$0.8 million and \$0.5 million, respectively, from the same period in 2011.

Underwriting income for the segment was \$11.3 million for the first nine months of 2012, compared to \$15.7 million for the same period in 2011. Results for 2012 reflected \$12.9 million of favorable development on prior years' loss and hurricane reserves, primarily on marine, fire and property reinsurance coverages. This included reserves established for claims associated with hurricanes in 2005, 2008 and 2011, as well as 2011 spring storms. Also included in this favorable development is \$3.0 million of favorable development on prior year crop business. Final settlement of the 2011 crop treaty year will occur in the fourth quarter of 2012. Offsetting this favorable development on prior year crop business was adverse loss experience on the 2012 crop reinsurance year, related to drought conditions across the United States. Results for 2012 have also been impacted by \$5.0 million in reserves established for Hurricane Isaac, and \$15.0 million in reserves established for spring storm losses, concentrated in our fire product. Current accident year losses from our inland marine and cargo lines further impacted 2012 results by \$2.6 million. In response to these losses, action to increase prices on these lines has been initiated, with us exiting accounts which remain unprofitable despite these actions. From a comparative standpoint, results for 2011 reflected \$15.3 million of favorable development on prior years' loss reserves, primarily on marine and DIC coverages (favorable settlement of a final claim for the Northridge earthquake), and crop business. Offsetting this favorable development slightly were increased reserves associated with 2005 and 2008 hurricanes, and the Japan earthquake and tsunami. The combined effect of these reserve changes was \$3.7 million. Results for 2011 also reflect losses on Hurricane Irene and spring storms, of \$6.0 million and \$13.0 million, respectively, and \$2.4 million of adverse current year development on marine yacht coverages. During 2012, we exited the marine yacht business due to adverse loss experience.

Segment results for 2012 translated into a combined ratio of 92.6, compared to 89.4 for the same period last year. The segment's loss ratio was 55.7 in 2012 compared to 54.4 in 2011. From an expense standpoint, the segment's expense ratio increased slightly to 36.9 for 2012 from 35.0 for 2011.

### ***Surety***

The surety segment recorded gross premiums written of \$86.8 million for the first nine months of 2012, an increase of \$6.5 million, or 8%, from the same period last year. CBIC contributed \$5.6 million of the premium growth in the

surety segment, posting \$16.6 million of gross premiums written for the period. In addition, premium growth was experienced within the Group's existing miscellaneous product, while the existing energy product was down slightly. The segment recorded underwriting income of \$21.4 million, compared to \$15.3 million for the same period last year. Results for 2012 included net favorable development on prior years' loss reserves, which improved the segment's underwriting results by \$9.4 million. From a comparative standpoint, 2011 results include favorable loss development which improved the segment's underwriting results by \$7.8 million. Partially offsetting this favorable development in 2011 was a \$2.4 million increase in IBNR reserves related to adverse current year loss experience on contract surety, which was largely due to claims against a single risk.

The combined ratio for the surety segment totaled 73.2 in 2012, versus 78.7 for the same period in 2011. The segment's loss ratio was 8.8 for 2012, compared to 11.0 for 2011, due largely to greater benefits in the current year related to favorable development on prior year reserves. From an expense standpoint, the segment's expense ratio decreased slightly to 64.4 for 2012 from 67.7 for 2011.

### INVESTMENT INCOME AND REALIZED CAPITAL GAINS

During the first nine months of 2012, net investment income decreased 6.5% from that reported for the same period in 2011. Both lower reinvestment rates and a higher allocation to tax-exempt municipals contributed to the decline in investment income. Because of their tax preference, municipals typically trade with lower nominal yields than taxable alternatives.

| (in thousands)                  | 9/30/2012            |        | 12/31/2011           |        |
|---------------------------------|----------------------|--------|----------------------|--------|
|                                 | Financial Stmt Value | %      | Financial Stmt Value | %      |
| Fixed income                    | \$ 1,444,700         | 73.7%  | \$ 1,406,550         | 74.0%  |
| Equity securities               | 402,099              | 20.5%  | 388,689              | 20.5%  |
| Cash and short-term investments | 113,503              | 5.8%   | 105,049              | 5.5%   |
| Total                           | \$ 1,960,302         | 100.0% | \$ 1,900,288         | 100.0% |

Our current equity allocation represents 21% of our total investment portfolio.

We believe our overall asset allocation best meets our strategy to preserve capital for policyholders, provide sufficient income to support insurance operations, and to effectively grow book value over a long-term investment horizon.

The average annual yields on our fixed income investments (excluding short-term investments) for the first nine months of 2012 and 2011 were as follows:

|                        | 2012  | 2011  |
|------------------------|-------|-------|
| <u>Pretax Yield</u>    |       |       |
| Taxable                | 3.99% | 4.22% |
| Tax-Exempt             | 3.16% | 3.64% |
| <u>After-tax yield</u> |       |       |
| Taxable                | 2.59% | 2.74% |

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Tax-Exempt

2.99%

3.45%

43

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The fixed income portfolio increased by \$38.1 million in the first nine months of 2012. The increase is mainly due to positive market performance as interest rates have declined. This portfolio had a tax-adjusted total return on a mark-to-market basis of 5.7%. Average fixed income duration was 4.9 at September 30, 2012, reflecting our current liability structure and sound capital position.

The equity portfolio increased by \$13.4 million during the first nine months of 2012, to \$402.1 million, and had a total return of 12.3% through September 30, 2012.

We recognized a total of \$16.2 million in net realized gains in the first nine months of 2012, compared to net realized gains of \$14.3 million in the first nine months of 2011.

The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of September 30, 2012, including fair value, cost basis, and unrealized gains and losses.

|                        | Cost<br>Basis | Fair Value | 9/30/2012<br>Unrealized |            | Net        | Unrealized<br>Gain/Loss % (1) |
|------------------------|---------------|------------|-------------------------|------------|------------|-------------------------------|
|                        |               |            | Gains                   | Losses     |            |                               |
|                        |               |            | (dollars in thousands)  |            |            |                               |
| Consumer Discretionary | \$ 20,429     | \$ 33,574  | \$ 13,145               |            | \$ 13,145  | 64.3%                         |
| Consumer Staples       | 18,364        | 37,948     | 19,584                  |            | 19,584     | 106.6%                        |
| Energy                 | 12,773        | 28,597     | 15,824                  |            | 15,824     | 123.9%                        |
| Financials             | 29,526        | 39,604     | 10,320                  | (242)      | 10,078     | 34.1%                         |
| Healthcare             | 10,517        | 24,393     | 13,876                  |            | 13,876     | 131.9%                        |
| Industrials            | 21,652        | 36,615     | 14,963                  |            | 14,963     | 69.1%                         |
| Materials              | 6,324         | 10,302     | 3,978                   |            | 3,978      | 62.9%                         |
| Information Technology | 22,363        | 30,123     | 7,918                   | (158)      | 7,760      | 34.7%                         |
| Telecommunications     | 10,053        | 17,858     | 8,412                   | (607)      | 7,805      | 77.6%                         |
| Utilities              | 48,449        | 70,166     | 21,759                  | (42)       | 21,717     | 44.8%                         |
| ETF                    | 53,978        | 72,919     | 18,941                  |            | 18,941     | 35.1%                         |
|                        | \$ 254,428    | \$ 402,099 | \$ 148,720              | \$ (1,049) | \$ 147,671 | 58.0%                         |

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

In addition to our equity portfolio shown above, we maintain an allocation to municipal fixed income securities. As of September 30, 2012, we had \$437.8 million in municipal securities. As of September 30, 2012, approximately 28% of our municipal bond portfolio maintains an AAA rating, and 98% of our municipal bond portfolio maintains an AA or better rating. The entire municipal bond portfolio is rated at least A or better. At December 31, 2011, approximately 95% of our municipal bond portfolio held an AA or better rating, while 100% were rated A or better.

### INCOME TAXES

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Our effective tax rate for the first nine months of 2012 was 31% compared to 33% for the same period in 2011. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate

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for the first nine months of 2012 was lower due to an increase in tax-favored investment income relative to underwriting income.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the first nine months of 2012 and 2011 as a result of the following:

| (in thousands)  | 2012             |            | 2011             |            |
|---|------------------|------------|------------------|------------|
|   | Amount           | %          | Amount           | %          |
| Provision for income taxes at the Statutory rate of 35% | \$ 39,955        | 35%        | \$ 50,210        | 35%        |
| Increase (reduction) in taxes resulting from:           |                  |            |                  |            |
| Tax exempt interest income                              | (2,157)          | -2%        | (1,809)          | -1%        |
| Dividends received deduction                            | (1,842)          | -2%        | (1,370)          | -1%        |
| Dividends paid deduction                                | (538)            | 0%         | (500)            | 0%         |
| Other items, net  | 490              | 0%         | 260              | 0%         |
| <b>Total tax expense</b>                                | <b>\$ 35,908</b> | <b>31%</b> | <b>\$ 46,791</b> | <b>33%</b> |

### THREE MONTHS ENDED SEPTEMBER 30, 2012 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2011

Consolidated revenues, as displayed in the table that follows, totaled \$169.6 million for the third quarter of 2012 compared to \$162.3 million for the same period in 2011.

| Consolidated revenues (in thousands)   | For the Three-Month Periods<br>Ended September 30, |                   |
|--|--|-------------------|
|  | 2012   | 2011              |
| Net premiums earned                    | \$ 149,943   | \$ 146,552        |
| Net investment income                  | 14,221   | 15,954            |
| Net realized investment gains (losses) | 5,481  | (177)             |
| <b>Total consolidated revenue</b>      | <b>\$ 169,645</b>                                  | <b>\$ 162,329</b> |

Consolidated revenue for the third quarter of 2012 increased \$7.3 million, or 5%, from the same period in 2011. Net premiums earned for the Group increased 2% for the quarter, led by growth in our casualty segment. Our acquisition of CBIC added \$13.0 million in the third quarter of 2012, up \$1.0 million from the third quarter of 2011. CBIC contributed three months of revenue in both 2012 and 2011. Net investment income decreased 11% to \$14.2 million due to lower reinvestment rates and increased allocation to tax-exempt municipal securities. Net realized investment gains, totaled \$5.5 million in the third quarter of 2012, compared to net realized investment losses of \$0.2 million in 2011.

Net after-tax earnings for the third quarter of 2012 totaled \$25.5 million, \$1.19 per diluted share, compared to \$24.0 million, \$1.12 per diluted share, for the same period in 2011. In the third quarter of 2012, favorable development on prior years loss reserves resulted in additional pretax earnings of \$20.5 million. Partially offsetting the prior year favorable development was \$5.0 million in losses from Hurricane Isaac, and \$1.3 million





of additional losses from 2012 spring storms. In addition, widespread drought conditions resulted in \$3.6 million of adverse current accident year loss experience on multi-peril crop business, which further offset favorable development. Comparatively, in the third quarter of 2011, favorable development on prior years' loss reserves resulted in additional pretax earnings of \$31.4 million, partially offset by \$6.5 million in Hurricane Irene losses, and \$4.8 million of adverse current year loss experience on contract surety and marine coverages.

During the third quarter of 2012, equity in earnings of unconsolidated investee totaled \$1.9 million from Maui Jim. This result was \$1.2 million higher than results for the same period last year, due to increased sales and improved foreign exchange results.

Results for the third quarter of 2012 included pretax net realized investment gains of \$5.5 million, compared to net realized investment losses of \$0.2 million, for the same period last year. Realized gains are taxed at the statutory rate of 35%.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$46.5 million, \$2.16 per diluted share, for the third quarter of 2012, compared to \$9.6 million, \$0.45 per diluted share, for the same period in 2011. Unrealized gains, net of tax, for the third quarter of 2012 were \$21.0 million, compared to unrealized losses, net of tax, of \$14.3 million for the same period in 2011.

## **RLI INSURANCE GROUP**

As reflected in the table below, gross premiums written for the Group increased 6% to \$195.9 million for the third quarter of 2012 from \$184.0 million in the third quarter of 2011. The casualty segment posted growth in premium writings, while property and surety were flat. Growth was driven by expansion efforts and new product initiatives coupled with improved pricing on select lines. Primary and reinsurance pricing continue to show signs of stabilizing with increased pricing on select lines. Underwriting income for the Group decreased \$3.0 million to \$18.5 million for the third quarter of 2012. Both periods were impacted by similar amounts of hurricane and spring storm losses. The result for 2012, however, included a reduced benefit for favorable development on prior year loss and hurricane reserves. Favorable development for the third quarter of 2012 totaled \$20.5 million, compared to \$31.4 million for the same period in 2011. The GAAP combined ratio totaled 87.7 in 2012 and 85.3 in 2011.

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|  | For the Three-Month Periods<br>Ended September 30, |            |
|--|--|------------|
|  | 2012   | 2011       |
| <b>Gross premiums written</b> (in thousands)     |  |            |
| Casualty   | \$ 99,970  | \$ 87,921  |
| Property   | 65,321   | 64,849     |
| Surety   | 30,591   | 31,252     |
| Total  | \$ 195,882   | \$ 184,022 |
| <b>Underwriting income (loss)</b> (in thousands) |  |            |
| Casualty   | \$ 10,806  | \$ 22,265  |
| Property   | (310)  | (1,813)    |
| Surety   | 8,034  | 1,072      |
| Total  | \$ 18,530  | \$ 21,524  |
| <b>Combined ratio</b>                            |  |            |
| Casualty   | 84.2   | 63.2       |
| Property   | 100.6  | 103.0      |
| Surety   | 70.3   | 96.0       |
| Total  | 87.7   | 85.3       |

*Casualty*

Gross premiums written for the casualty segment increased 14%, totaling \$100.0 million for the third quarter of 2012, compared to \$87.9 million from the same period last year, due to growth in existing products and moderate price improvements. Commercial umbrella recorded gross premiums written of \$14.1 million, an increase of \$7.8 million, or 122%, from the same period last year. A majority of this growth was from increased opportunities to write umbrella over our existing general liability policies. Our professional services product, which was launched in 2009 to provide professional liability coverage for design professionals and which now offers additional coverages to its target market, posted \$11.6 million in gross premiums written during the third quarter of 2012, up \$2.4 million, or 26%, from the same period last year. CBIC expansion efforts contributed \$8.4 million of gross premiums written to the casualty segment for the three-month period, up 11% from the prior year period. In addition, transportation recorded gross premiums written of \$14.4 million for the third quarter of 2012, up \$1.9 million, or 15% from the same period last year.

In total, the casualty segment recorded underwriting income of \$10.8 million, compared to \$22.3 million for the same period last year. Both periods included favorable development on prior years' loss reserves, but the impact in 2011 was \$15.3 million greater than in 2012. Products with favorable development in 2012 included general liability, commercial umbrella, personal umbrella, and specialty programs. From an accident year standpoint, the majority of the favorable development occurred on more recent accident years (2011 and 2006-2008). Due to positive emergence, during the third quarter of 2012, we released reserves which improved the segment's underwriting results by \$13.5 million. From a comparative standpoint, results for 2011 included \$28.8 million of favorable loss experience on prior accident years, primarily for general liability, commercial umbrella, transportation, and specialty programs.

Overall, the combined ratio for the casualty segment was 84.2 for 2012 compared to 63.2 in 2011. The segment's loss ratio was 47.4 in 2012 compared to 24.4 in 2011. The increase is due largely to the aforementioned higher amount of favorable development in 2011 on prior accident years. Offsetting this increase, however, current accident year loss ratio estimates for certain lines improved during the quarter, and served to lower the 2012 third quarter current accident year loss ratio by four points. The expense ratio for the casualty segment was 36.8 for the third quarter of 2012 compared to 38.8 for the same period of 2011. Bonus and profit sharing-related expenses related to the favorable development totaled \$0.6 million in 2012, down from \$1.4 million in 2011, which contributed to the slight decrease in the segment's expense ratio.

### *Property*

Gross premiums written for the Group's property segment totaled \$65.3 million for the third quarter of 2012, flat from the same period last year. While flat at the segment level, premium growth was achieved on select lines, largely amongst our mature products. Our fire product contributed \$18.6 million in gross premiums written, an increase of \$3.0 million, or 19% from the third quarter of 2011, while DIC contributed \$11.9 million in premiums, a 6% increase from the same period last year. In addition, marine grew by 2% to \$16.6 million in the third quarter of 2012, due largely to an increase in premiums from our inland marine product. Offsetting these, our crop business decreased from the same period last year, as did our property reinsurance program, which was down 6% from the same period last year.

Underwriting loss for the segment was \$0.3 million for the third quarter of 2012, compared to a loss of \$1.8 million for the same period in 2011. Results for 2012 included \$5.0 million of losses from Hurricane Isaac, and \$1.3 million of increased losses related to 2012 spring storms. Also included is \$3.6 million of adverse current accident year loss experience on multi-peril crop business associated with drought conditions across the United States during 2012. Current accident year losses from our inland marine and cargo lines further impacted 2012 results by \$2.6 million. In response to these losses, action to increase prices on these lines has been initiated, with us exiting accounts which remain unprofitable despite these actions. These losses were partially offset by \$3.9 million of net favorable development on prior years' loss and hurricane reserves, primarily on our marine, fire, and crop business. From a comparative standpoint, underwriting results for 2011 included \$6.0 million of Hurricane Irene losses and \$2.4 million of adverse current year development on marine yacht coverages. Partially offsetting these was \$1.7 million of favorable development on prior years' loss reserves, primarily on marine coverages.

Segment results for the third quarter of 2012 translate into a combined ratio of 100.6 compared to 103.0 for the same period last year. The segment's loss ratio decreased to 65.6 from 73.3 in 2011. Although both periods experienced similar amounts of hurricane and spring storm losses, 2012 was more positively impacted by favorable development on prior years' loss reserves. From an expense standpoint, the segment's expense ratio for the third quarter was 35.0 for 2012, compared to 29.7 in 2011. The higher expense ratio for 2012 is due to changes in mix of business and decreases in net earned premiums associated with crop reinsurance. Prior year results for the segment include a higher

relative percentage of crop reinsurance business, which carries a lower expense ratio, than the current year.

### **Surety**

The surety segment recorded gross premiums written of \$30.6 million for the third quarter of 2012, a decrease of \$0.7 million, or 2%, from the same period last year. CBIC contributed \$6.0 million of the premium in the surety segment, a decrease of \$0.4 million from the prior year period. However, premium growth was experienced within the Group's mid-market line, up 11%, with \$7.4 million in premiums for the third quarter. The surety segment recorded underwriting income of \$8.0 million, compared to \$1.1 million for the same period last year. Results for 2012 included favorable development on prior accident years' loss reserves, which improved the segment's underwriting results by \$3.2 million. From a comparative standpoint, 2011 results included favorable loss development which improved the segment's underwriting results by \$0.9 million. Offsetting this favorable development in 2011, adverse current year loss experience on contract surety led to an increase in IBNR reserves of \$2.4 million, due largely to claims against a single risk.

The combined ratio for the surety segment totaled 70.3 for the third quarter of 2012, versus 96.0 for the same period in 2011. The segment's loss ratio was 8.9 for 2012, compared to 24.5 for 2011, as favorable development on prior years' reserves provided a greater positive impact to results for 2012. The expense ratio for the third quarter was 61.4 for 2012, compared to 71.5 in 2011, as cost savings resulting from the CBIC integration have begun to materialize within segment results.

### **INVESTMENT INCOME AND REALIZED CAPITAL GAINS**

Our investment portfolio generated net dividend and interest income of \$14.2 million during the third quarter of 2012, a decrease of 10.9% from that reported for the same period in 2011. The decline in investment income was due to lower reinvestment rates as well as a higher allocation to tax-exempt municipals which have lower nominal yields than taxable alternatives. On an after-tax basis, investment income decreased by 6.9%.

Yields on our fixed income investments for the third quarter of 2012 and 2011 are as follows:

|                        | 3Q 2012 | 3Q 2011 |
|------------------------|---------|---------|
| <u>Pretax Yield</u>    |         |         |
| Taxable                | 3.90%   | 4.01%   |
| Tax-Exempt             | 2.79%   | 3.55%   |
| <u>After-tax yield</u> |         |         |
| Taxable                | 2.54%   | 2.61%   |
| Tax-Exempt             | 2.64%   | 3.36%   |

We recognized \$5.5 million in realized gains in the third quarter of 2012, compared to realized losses of \$0.2 million in the third quarter of 2011. Investment gains during the quarter were taken in the normal course of rebalancing both the equity and fixed income portfolios. We did not record any realized losses associated with OTTI of securities during the third quarter of 2012.



**INCOME TAXES**

Our effective tax rate for the third quarter of 2012 was 30% compared to 32% for the same period in 2011. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the third quarter of 2012 was lower due to an increase in tax-favored investment income relative to underwriting income.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the third quarter of 2012 and 2011 as a result of the following:

| (in thousands)  | 2012      |     | 2011      |     |
|---|-----------|-----|-----------|-----|
|   | Amount    | %   | Amount    | %   |
| Provision for income taxes at the Statutory rate of 35% | \$ 12,768 | 35% | 12,218    | 35% |
| Increase (reduction) in taxes resulting from:           |           |     |           |     |
| Tax exempt interest income                              | (826)     | -2% | (601)     | -2% |
| Dividends received deduction                            | (624)     | -2% | (498)     | -1% |
| Dividends paid deduction                                | (185)     | -1% | (164)     | 0%  |
| Other items, net  | (116)     | 0%  | (17)      | 0%  |
| Total tax expense                                       | \$ 11,017 | 30% | \$ 10,938 | 32% |

**LIQUIDITY AND CAPITAL RESOURCES**

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

The following table summarizes cash flows provided by (used in) our activities for the nine-month periods ended September 30, 2012 and 2011:

|                      | 2012           |  | 2011        |  |
|----------------------|----------------|--|-------------|--|
|                      | (in thousands) |  |             |  |
| Operating cash flows | \$ 13,154      |  | \$ 115,922  |  |
| Investing cash flows | \$ (48,810)    |  | \$ (98,455) |  |
| Financing cash flows | \$ (14,227)    |  | \$ (17,467) |  |
| Total                | \$ (49,883)    |  | \$          |  |

Cash flows from operating activities were positive for the first nine months of the current year, though considerably less than the same period in 2011. This disparity is a result of collateral that was being held on a large commercial surety account which was returned and replaced with a letter of credit, resulting in a \$50.0 million cash outflow in the second quarter of the current year. The collateral was originally received in the second quarter of 2011, thereby increasing 2011 operating cash flows by \$50.0 million. Cash outflows from investing activities during the first nine months of 2012





decreased compared to 2011 as our purchase of CBIC resulted in a higher use of cash in the prior year.

We have \$100.0 million in long-term debt outstanding. On December 12, 2003, we completed a public debt offering, issuing \$100.0 million in senior notes maturing January 15, 2014 (a 10-year maturity), and paying interest semi-annually at the rate of 5.95% per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. The estimated fair value for the senior note at September 30, 2012 was \$104.6 million. The fair value of our long-term debt is estimated based on the limited observable prices that reflect thinly traded securities.

As of September 30, 2012, we had cash, short-term investments and other investments maturing within one year of approximately \$110.6 million and investments of \$254.1 million maturing within five years. As of September 30, 2012, our short-term investments were held primarily in prime and government/agency funds within multiple fund families. All funds are NAIC-approved, AAA-rated, and maintain average weighted maturities of less than 60 days. Holdings within each of these funds comply with regulatory limitations. Whereas our strategy is to be fully invested at all times, short-term investments in excess of demand deposit balances are considered a component of investment activities, and thus are classified as investments in our consolidated balance sheets.

We also maintain a revolving line of credit with JP Morgan Chase, which permits us to borrow up to an aggregate principal amount of \$25.0 million. Under certain conditions, the line may be increased up to an aggregate principal amount of \$50.0 million. The facility has a three-year term that expires on May 31, 2014. As of September 30, 2012 and during the nine-month period ended, no amounts were outstanding on this facility.

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

We have not had any liquidity issues affecting our operations as we have sufficient cash flow to support operations. In addition to the line of credit, our highly liquid investment portfolio and additional reverse repurchase debt capacity provide additional sources of liquidity.

We maintain a diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of September 30, 2012, our investment portfolio had a book value of \$2.0 billion. Invested assets at September 30, 2012, increased by \$60.0 million from December 31, 2011.

As of September 30, 2012, our investment portfolio had the following asset allocation breakdown:

**Portfolio Allocation**

(in thousands)

| Asset Class                                 | Cost or Amortized Cost | Fair Value          | Unrealized Gain/(Loss) | % of Total Fair Value | Quality*  |
|---|------------------------|---------------------|------------------------|-----------------------|-----------|
| U.S. agencies                               | \$ 29,703              | \$ 30,020           | \$ 317                 | 1.5%                  | AA        |
| Corporates                                  | 543,236                | 591,070             | 47,834                 | 30.1%                 | A         |
| Mortgage-backed                             | 253,616                | 272,282             | 18,666                 | 13.9%                 | AA        |
| ABS/CMO**                                   | 82,752                 | 87,701              | 4,949                  | 4.5%                  | AAA       |
| Non-U.S. govt. & agency                     | 8,408                  | 9,288               | 880                    | 0.5%                  | AA        |
| U.S. government                             | 16,359                 | 16,752              | 393                    | 0.9%                  | AA        |
| States, political subdivisions and revenues | 419,745                | 437,809             | 18,064                 | 22.3%                 | AA        |
| <b>Total Fixed Income</b>                   | <b>\$ 1,353,819</b>    | <b>\$ 1,444,922</b> | <b>\$ 91,103</b>       | <b>73.7%</b>          | <b>AA</b> |
| <b>Equities</b>                             | <b>\$ 254,428</b>      | <b>\$ 402,099</b>   | <b>\$ 147,671</b>      | <b>20.5%</b>          |           |
| <b>Cash and short-term investments</b>      | <b>\$ 113,503</b>      | <b>\$ 113,503</b>   |                        | <b>5.8%</b>           |           |
| <b>Total Portfolio</b>                      | <b>\$ 1,721,750</b>    | <b>\$ 1,960,524</b> | <b>\$ 238,774</b>      | <b>100.0%</b>         |           |

\*Quality ratings provided by Moody's and S&P

\*\*Asset-backed and collateralized mortgage obligations

Our investment portfolio does not have any exposure to credit default swaps or derivatives.

As of September 30, 2012, our fixed income portfolio had the following rating distribution:

|              |               |
|--------------|---------------|
| <b>AAA</b>   | <b>14.5%</b>  |
| <b>AA</b>    | <b>47.1%</b>  |
| <b>A</b>     | <b>27.3%</b>  |
| <b>BBB</b>   | <b>10.8%</b>  |
| <b>NR</b>    | <b>0.3%</b>   |
| <b>Total</b> | <b>100.0%</b> |

As of September 30, 2012, the duration of the fixed income portfolio was 4.9 years. Our fixed income portfolio remained well diversified, with 630 individual issues as of September 30, 2012.

Our investment portfolio has limited exposure to structured asset-backed securities (ABS). As of September 30, 2012, we had \$21.6 million in ABS which are pools of assets collateralized by cash flows from several types of loans, including home equity, credit cards, autos, and similar obligations. The majority of our asset-backed portfolio is comprised of rate reduction utility bonds.

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As of September 30, 2012 we had \$66.1 million in commercial mortgage backed securities (CMBS) and \$272.3 million in residential mortgage backed securities backed by government sponsored enterprises (GSEs - Freddie Mac, Fannie Mae and Ginnie Mae). Excluding the GSE backed MBS, our exposure to ABS and CMBS was 4.5 percent of our investment portfolio at quarter end.

At September 30, 2012, our equity portfolio had a fair value of \$402.1 million and is also a source of liquidity. The securities within the equity portfolio

remain primarily invested in large-cap issues with strong dividend performance. In the equity portfolio, the strategy remains one of value investing, with security selection taking precedence over market timing. We use a buy-and-hold strategy, minimizing both transactional costs and taxes.

As of September 30, 2012, our equity portfolio had a dividend yield of 3.1% compared to 2.1% for the S&P 500 index. Because of the corporate dividend-received-deduction applicable to our dividend income, we pay an effective tax rate of only 14.2% on dividends, compared to 35.0% on taxable interest and 5.3% on municipal bond interest income. The equity portfolio is managed in a diversified and granular manner, with 81 individual names and no single stock exposure greater than 2% of the equity portfolio.

Our capital structure is comprised of equity and debt outstanding. As of September 30, 2012, our capital structure consisted of \$100.0 million in 10-year maturity senior notes maturing in 2014 (long-term debt) and \$894.4 million of shareholders' equity. Debt outstanding comprised 10.1% of total capital as of September 30, 2012.

We paid a quarterly cash dividend of \$0.32 per share on September 20, 2012, the same amount as the prior quarter. We have paid dividends for 145 consecutive quarters and increased dividends in each of the last 37 years.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authorities of Illinois. The maximum dividend distribution in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Insurance Company (RLI Ins.) policyholder earned surplus as of December 31 of the preceding year or the net income of RLI Ins. for the 12-month period ending December 31 of the preceding year. Stand-alone net income for RLI Ins. was \$139.0 million for 2011, while stand-alone policyholder earned surplus was \$710.2 million. Based on the calculation of this limitation, the maximum dividend distribution that can be paid by RLI Insurance for any rolling 12-month period ending during 2012, without prior approval, would be \$139.0 million, which represents RLI Insurance's net income for 2011. A dividend of \$13.0 million was paid by RLI Insurance Company to RLI Corp. on September 24, 2012 and represents the total paid in the first nine months of 2012. The dividend was used by RLI Corp. to support shareholder dividends, interest payments, and general operating expenses. Dividends paid in the last three months of 2011 totaled \$125.0 million which included amounts paid to RLI Corp. to support the special dividend RLI Corp. paid to its shareholders on December 20, 2011. As a result, dividends in excess of \$1.0 million prior to December 15, 2012 will require approval from the Illinois regulatory authorities.

Interest and fees on debt obligations totaled \$4.5 million for the first nine months of 2012 and 2011. As of September 30, 2012, outstanding debt balances totaled \$100.0 million, the same amount outstanding at September 30, 2011. Debt balances at the end of both quarters were comprised of \$100.0 million in senior notes. We have incurred interest expense on debt at the following average interest rates for the nine-month periods ended September 30, 2012 and 2011:

|                | 2012  | 2011  |
|----------------|-------|-------|
| Line of Credit | NA    | NA    |
| Senior Notes   | 6.02% | 6.02% |
| Total Debt     | 6.02% | 6.02% |

### ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of economic losses due to adverse changes in the estimated fair value of a financial instrument as the result of changes in equity prices, interest rates, foreign currency exchange rates and commodity prices. Historically, our primary market risks have been equity price risk associated with investments in equity securities and interest rate risk associated with investments in fixed maturities. We have limited exposure to both foreign currency risk and commodity risk.

Credit risk is the potential loss resulting from adverse changes in an issuer's ability to repay its debt obligations. We monitor our portfolio to ensure that credit risk does not exceed prudent levels. We have consistently invested in high credit quality, investment grade securities. Our fixed maturity portfolio has an average rating of AA, with 89% rated A or better by at least two nationally recognized rating organization.

On an overall basis, our exposure to market risk has not significantly changed from that reported in our December 31, 2011 Annual Report on Form 10-K.

### ITEM 4. Controls and Procedures

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

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

In April 2011, we acquired 100 percent of the common stock equity of Contractors Bonding and Insurance Company (CBIC) through an acquisition of its holding company, Data and Staff Service Co. In accordance with Securities and Exchange Commission rules in the year of consolidation, management excluded the internal controls of CBIC from its annual assessment of the effectiveness of our internal control over financial reporting (Section 404) for 2011. We have engaged in refining and harmonizing the internal controls and processes of the acquired business with those of our company, and will incorporate the



internal controls of CBIC into our annual assessment beginning with our assessment as of December 31, 2012.

No changes were made to our internal control over financial reporting (which, for purposes of this evaluation, included the internal control over financial reporting for CBIC from and after the one year anniversary of the acquisition), during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

**Item 1.**                    **Legal Proceedings** - There were no material changes to report.

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

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

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

Our current \$100 million share repurchase program was implemented by our Board of Directors in May 2010. The repurchase program may be suspended or discontinued at any time without prior notice. During the third quarter of 2012, no repurchases were made. We have not repurchased shares under this program since the third quarter of 2011. We have \$87.5 million of remaining capacity from the repurchase program.

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

**Item 4.**                    **Mine Safety Disclosures** Not Applicable.

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

**Item 6.**                    **Exhibits**

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

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

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

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

Exhibit 101 XBRL-Related Documents



**SIGNATURES**

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

RLI Corp.

/s/Thomas L. Brown  
Thomas L. Brown  
Vice President, Chief Financial Officer  
(Principal Financial and Chief Accounting Officer)

Date: October 29, 2012