

RLI CORP  
Form 10-Q  
October 27, 2014  
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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, 2014

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<br>(State or other jurisdiction of<br>incorporation or organization)      | 37-0889946<br>(I.R.S. Employer<br>Identification Number) |
| 9025 North Lindbergh Drive, Peoria, IL<br>(Address of principal executive offices) | 61615<br>(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<br>(Do not check if a smaller reporting company) | 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:

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As of October 13, 2014, the number of shares outstanding of the registrant's Common Stock was 43,027,044.

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## 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, |            |
|---|--|------------|
|   | 2014   | 2013       |
| Net premiums earned                             | \$ 177,747   | \$ 163,702 |
| Net investment income                           | 14,200   | 13,598     |
| Net realized investment gains                   | 5,708  | 10,999     |
| Consolidated revenue                            | \$ 197,655   | \$ 188,299 |
| Losses and settlement expenses                  | 76,019   | 64,246     |
| Policy acquisition costs                        | 58,180   | 54,176     |
| Insurance operating expenses                    | 13,120   | 13,462     |
| Interest expense on debt                        | 1,857  | 1,513      |
| General corporate expenses                      | 2,800  | 2,157      |
| Total expenses                                  | \$ 151,976   | \$ 135,554 |
| Equity in earnings of unconsolidated investees  | 2,915  | 2,564      |
| Earnings before income taxes                    | \$ 48,594  | \$ 55,309  |
| Income tax expense                              | 15,340   | 17,662     |
| Net earnings                                    | \$ 33,254  | \$ 37,647  |
| Other comprehensive earnings (loss), net of tax | (12,353)   | (1,946)    |
| Comprehensive earnings                          | \$ 20,901  | \$ 35,701  |
| Earnings per share:                             |  |            |
| Basic:  |  |            |
| Basic net earnings per share                    | \$ 0.77  | \$ 0.88    |
| Basic comprehensive earnings per share          | \$ 0.49  | \$ 0.83    |

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Diluted:

|  |         |         |
|--|---------|---------|
| Diluted net earnings per share                       | \$ 0.76 | \$ 0.86 |
| Diluted comprehensive earnings per share             | \$ 0.48 | \$ 0.82 |
| Weighted average number of common shares outstanding |         |         |
| Basic  | 43,026  | 42,843  |
| Diluted  | 43,712  | 43,546  |
| Cash dividends paid per common share                 | \$ 0.18 | \$ 0.17 |

See accompanying notes to 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, |            |
|--|---|------------|
|  | 2014  | 2013       |
| Net premiums earned                                  | \$ 507,483  | \$ 462,406 |
| Net investment income                                | 41,764  | 39,331     |
| Net realized investment gains                        | 22,640  | 18,425     |
| Consolidated revenue                                 | \$ 571,887  | \$ 520,162 |
| Losses and settlement expenses                       | 220,380   | 191,301    |
| Policy acquisition costs                             | 168,387   | 156,014    |
| Insurance operating expenses                         | 39,187  | 37,916     |
| Interest expense on debt                             | 5,582   | 4,538      |
| General corporate expenses                           | 7,547   | 6,235      |
| Total expenses                                       | \$ 441,083  | \$ 396,004 |
| Equity in earnings of unconsolidated investees       | 12,204  | 10,696     |
| Earnings before income taxes                         | \$ 143,008  | \$ 134,854 |
| Income tax expense                                   | 45,060  | 42,458     |
| Net earnings   | \$ 97,948   | \$ 92,396  |
| Other comprehensive earnings (loss), net of tax      | 25,318  | (17,874)   |
| Comprehensive earnings                               | \$ 123,266  | \$ 74,522  |
| Earnings per share:                                  |   |            |
| Basic:   |   |            |
| Basic net earnings per share                         | \$ 2.28   | \$ 2.17    |
| Basic comprehensive earnings per share               | \$ 2.87   | \$ 1.75    |
| Diluted:   |   |            |
| Diluted net earnings per share                       | \$ 2.24   | \$ 2.13    |
| Diluted comprehensive earnings per share             | \$ 2.82   | \$ 1.72    |
| Weighted average number of common shares outstanding |   |            |
| Basic  | 43,004  | 42,673     |



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|                                      |         |         |
|--------------------------------------|---------|---------|
| Diluted                              | 43,692  | 43,330  |
| Cash dividends paid per common share | \$ 0.53 | \$ 0.50 |

See accompanying notes to 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<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| <b>ASSETS</b>                                     |                          |                         |
| Investments                                       |                          |                         |
| Fixed income                                      |                          |                         |
| Available-for-sale, at fair value                 | \$ 1,545,530             | \$ 1,440,052            |
| Held-to-maturity, at amortized cost               | 650                      | 651                     |
| Equity securities, at fair value                  | 419,022                  | 418,654                 |
| Short-term investments, at cost                   | 10,063                   | 23,232                  |
| Other invested assets                             | 11,688                   | -                       |
| Cash  | 77,037                   | 39,469                  |
| Total investments and cash                        | \$ 2,063,990             | \$ 1,922,058            |
| Accrued investment income                         | 13,595                   | 15,710                  |
| Premiums and reinsurance balances receivable      | 175,293                  | 152,509                 |
| Ceded unearned premium                            | 62,646                   | 60,407                  |
| Reinsurance balances recoverable on unpaid losses | 353,228                  | 354,924                 |
| Deferred policy acquisition costs                 | 68,372                   | 61,508                  |
| Property and equipment                            | 42,400                   | 40,261                  |
| Investment in unconsolidated investees            | 67,250                   | 49,793                  |
| Goodwill and intangibles                          | 74,172                   | 74,876                  |
| Other assets                                      | 12,537                   | 8,264                   |
| <b>TOTAL ASSETS</b>                               | <b>\$ 2,933,483</b>      | <b>\$ 2,740,310</b>     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |                          |                         |
| Liabilities:                                      |                          |                         |
| Unpaid losses and settlement expenses             | \$ 1,152,413             | \$ 1,129,433            |
| Unearned premiums                                 | 429,867                  | 392,081                 |
| Reinsurance balances payable                      | 37,683                   | 47,334                  |
| Funds held  | 53,834                   | 61,656                  |
| Income taxes-deferred                             | 77,086                   | 57,801                  |
| Bonds payable, long-term debt                     | 149,615                  | 149,582                 |
| Accrued expenses                                  | 52,392                   | 59,596                  |
| Other liabilities                                 | 47,080                   | 13,861                  |
| <b>TOTAL LIABILITIES</b>                          | <b>\$ 1,999,970</b>      | <b>\$ 1,911,344</b>     |

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Shareholders' Equity

|   |                     |                     |
|---|---------------------|---------------------|
| Common stock (\$1 par value, 100,000,000 shares authorized)           |                     |                     |
| (65,957,258 shares issued, 43,027,044 shares outstanding at 9/30/14)  |                     |                     |
| (65,912,638 shares issued, 42,982,424 shares outstanding at 12/31/13) | \$ 65,957           | \$ 65,913           |
| Paid-in capital   | 212,733             | 208,705             |
| Accumulated other comprehensive earnings                              | 161,345             | 136,027             |
| Retained earnings   | 886,477             | 811,320             |
| Deferred compensation   | 11,687              | 11,562              |
| Less: Treasury shares at cost   |                     |                     |
| (22,930,214 shares at 9/30/14 and 12/31/13)                           | (404,686)           | (404,561)           |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>                                     | <b>\$ 933,513</b>   | <b>\$ 828,966</b>   |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                     | <b>\$ 2,933,483</b> | <b>\$ 2,740,310</b> |

See accompanying notes to the unaudited condensed consolidated interim financial statements.

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

| (in thousands)                                    | For the Nine-Month Periods<br>Ended September 30, |              |
|---|---|--------------|
|   | 2014  | 2013         |
| Net cash provided by operating activities         | \$ 85,894   | \$ 81,736    |
| <b>Cash Flows from Investing Activities</b>       |   |              |
| Investments purchased                             | \$ (422,287)                                      | \$ (358,510) |
| Investments sold                                  | 285,886   | 221,133      |
| Investments called or matured                     | 77,611  | 114,929      |
| Net change in short-term investments              | 40,027  | 10,869       |
| Net property and equipment purchased              | (5,543)   | (10,766)     |
| Investment in equity method investee              | (5,301)   | -            |
| Net cash used in investing activities             | \$ (29,607)                                       | \$ (22,345)  |
| <b>Cash Flows from Financing Activities</b>       |   |              |
| Cash dividends paid                               | \$ (22,791)                                       | \$ (21,354)  |
| Stock plan share issuance                         | 3,672   | 159          |
| Excess tax benefit from exercise of stock options | 400   | 4,888        |
| Net cash used in financing activities             | \$ (18,719)                                       | \$ (16,307)  |
| Net increase in cash                              | \$ 37,568   | \$ 43,084    |
| Cash at the beginning of the period               | \$ 39,469   | \$ 44,314    |
| Cash at September 30                              | \$ 77,037   | \$ 87,398    |

See accompanying notes to the unaudited condensed consolidated interim financial statements.

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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 2013 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, 2014 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 2014-01, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects

This ASU permits an entity to account for investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. The proportional amortization method requires an entity to amortize the initial cost of the investment in proportion to the amount of tax credits and other tax benefits received and recognizes the net investment performance as a component of income tax expense.

We elected to early adopt this ASU during the third quarter of 2014 in conjunction with our investment in Federal Low Income Housing Tax Credits. A discussion of our investment and the required disclosures of this accounting standards update are included in Note 2 to these unaudited condensed consolidated interim financial statements.

#### C. PROSPECTIVE ACCOUNTING STANDARDS

There are no prospective accounting standards which would impact our financial statements as of September 30, 2014.

#### 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. Goodwill and intangibles totaled \$74.2 million at September 30, 2014.

Goodwill resulting from acquisitions completed prior to 2011 totaled \$26.2 million and is attributable to our surety segment. Goodwill and intangible assets resulting from the Contractors Bonding and Insurance Company (CBIC) acquisition in April 2011 totaled \$32.0 million. The CBIC-related assets include goodwill attributable to our casualty and surety segments of \$5.3 million and \$15.1 million, respectively, and an indefinite-lived intangible asset in the amount of \$8.8 million. Annual impairment testing was performed on each of these goodwill and indefinite-lived intangible assets during the second quarter of 2014. Based upon these reviews, none of the assets were impaired. In addition, as of September 30, 2014, there were no triggering events that occurred that would suggest an updated review was necessary. Definite-lived intangible assets related to the CBIC acquisition totaled \$2.8 million, net of amortization, as of September 30, 2014.

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The remaining \$16.0 million of goodwill and intangibles relates to our purchase of Rockbridge Underwriting Agency (Rockbridge) in November 2012. Of this amount, \$12.4 million is recorded as goodwill attributable to our casualty segment. The remaining \$3.6 million relates to definite-lived intangible assets, net of amortization, as of September 30, 2014. Impairment testing was performed on this goodwill asset during the third quarter of 2014 as actual premium production has fallen below levels anticipated at acquisition. We used a quantitative analysis to determine the impact of the difference and concluded that the asset was not impaired.

The aforementioned definite-lived intangible assets are amortized against future operating results based on their estimated useful lives. Amortization of intangible assets resulting from the acquisitions of CBIC and Rockbridge was \$0.2 million for the third quarter of 2014, and \$0.7 million for the nine months ended September 30, 2014.

## 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 interim financial statements.

| (in thousands, except<br>per share data)   | For the Three-Month Period<br>Ended September 30, 2014 |                         |                     | For the Three-Month Period<br>Ended September 30, 2013 |                         |                     |
|--|--|-------------------------|---------------------|--|-------------------------|---------------------|
|  | Income<br>(Numerator)                                  | Shares<br>(Denominator) | Per Share<br>Amount | Income<br>(Numerator)                                  | Shares<br>(Denominator) | Per Share<br>Amount |
| Basic EPS                                  |  |                         |                     |  |                         |                     |
| Income available to<br>common shareholders | \$ 33,254  | 43,026                  | \$ 0.77             | \$ 37,647  | 42,843                  | \$ 0.88             |
| Effect of Dilutive<br>Securities           |  |                         |                     |  |                         |                     |

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|   |  |                      |                  |  |                      |                  |
|---|--|----------------------|------------------|--|----------------------|------------------|
| Stock options                           | -  | 686                  |                  | -  | 703                  |                  |
| <b>Diluted EPS</b>                      |  |                      |                  |  |                      |                  |
| Income available to common shareholders | \$ 33,254  | 43,712               | \$ 0.76          | \$ 37,647  | 43,546               | \$ 0.86          |
|   | For the Nine-Month Period Ended September 30, 2014 |                      |                  | For the Nine-Month Period Ended September 30, 2013 |                      |                  |
| (in thousands, except per share data)   | Income (Numerator)                                 | Shares (Denominator) | Per Share Amount | Income (Numerator)                                 | Shares (Denominator) | Per Share Amount |
| <b>Basic EPS</b>                        |  |                      |                  |  |                      |                  |
| Income available to common shareholders | \$ 97,948  | 43,004               | \$ 2.28          | \$ 92,396  | 42,673               | \$ 2.17          |
| Effect of Dilutive Securities           |  |                      |                  |  |                      |                  |
| Stock options                           | -  | 688                  |                  | -  | 657                  |                  |
| <b>Diluted EPS</b>                      |  |                      |                  |  |                      |                  |
| Income available to common shareholders | \$ 97,948  | 43,692               | \$ 2.24          | \$ 92,396  | 43,330               | \$ 2.13          |

F. COMPREHENSIVE EARNINGS

Our comprehensive earnings include net earnings plus unrealized gains/losses on our available-for-sale investment securities, net of tax. In reporting comprehensive earnings on a net basis in the statement of earnings, we used the federal statutory tax rate of 35 percent. The following table illustrates the changes in the balance of each component of



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accumulated other comprehensive earnings for each period presented in the unaudited condensed consolidated interim financial statements.

| (in thousands)   | For the Three-Month Periods<br>Ended September 30, |            | For the Nine-Month Periods<br>Ended September 30, |             |
|--|--|------------|---|-------------|
|  | 2014   | 2013       | 2014  | 2013        |
| Unrealized Gains/Losses on Available-for-Sale Securities           |  |            |   |             |
| Beginning balance  | \$ 173,698   | \$ 127,242 | \$ 136,027  | \$ 143,170  |
| Other comprehensive earnings before reclassifications              | (8,642)  | 5,203      | 40,032  | (5,354)     |
| Amounts reclassified from accumulated other comprehensive earnings | (3,711)  | (7,149)    | (14,714)  | (12,520)    |
| Net current-period other comprehensive earnings                    | \$ (12,353)  | \$ (1,946) | \$ 25,318   | \$ (17,874) |
| Ending balance   | \$ 161,345   | \$ 125,296 | \$ 161,345  | \$ 125,296  |

The sale or other-than-temporary impairment of an available-for-sale security results in amounts being reclassified from accumulated other comprehensive earnings to current period net earnings. The effects of reclassifications out of accumulated other comprehensive earnings by the respective line items of net earnings are presented in the following table.

| (in thousands)   | Amount Reclassified from Accumulated Other Comprehensive Earnings |           |   |           | Affected line item in the Statement of Earnings |
|--|---|-----------|---|-----------|---|
|  | For the Three-Month Periods Ended<br>September 30,                |           | For the Nine-Month Periods Ended<br>September 30, |           |   |
| Component of Accumulated Other Comprehensive Earnings        | 2014  | 2013      | 2014  | 2013      |   |
| Unrealized gains and losses on available-for-sale securities | \$ 5,709  | \$ 10,998 | \$ 22,637   | \$ 19,261 | Net realized investment gains                   |
|  | -   | -         | -   | -         | Other-than-temporary impairment (OTTI)          |
|  | \$ 5,709  | \$ 10,998 | \$ 22,637   | \$ 19,261 | losses on investments                           |
|  | (1,998)   | (3,849)   | (7,923)   | (6,741)   | Earnings before income taxes                    |
|  |   |           |   |           | Income tax expense                              |

|          |          |           |           |              |
|----------|----------|-----------|-----------|--------------|
| \$ 3,711 | \$ 7,149 | \$ 14,714 | \$ 12,520 | Net earnings |
|----------|----------|-----------|-----------|--------------|

## 2. INVESTMENTS

Our investments include fixed income debt securities and common stock equity securities. As disclosed in our 2013 Annual Report on Form 10-K, we present our investments in these classes as available-for-sale and held-to-maturity. 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.

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## Available-for-Sale Securities

The amortized cost and fair value of available-for-sale securities at September 30, 2014 and December 31, 2013 were as follows:

| Available-for-sale<br>(in thousands) |                              |                              |                               |               |
|--------------------------------------|------------------------------|------------------------------|-------------------------------|---------------|
|                                      | 9/30/2014                    |                              |                               |               |
| Asset Class                          | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. agency                          | \$ 6,383                     | \$ 147                       | \$ (14)                       | \$ 6,516      |
| Corporate                            | 563,120                      | 23,639                       | (2,603)                       | 584,156       |
| Mtge/ABS/CMBS*                       | 392,687                      | 9,627                        | (3,294)                       | 399,020       |
| Non-U.S. govt. & agency              | 9,861                        | 696                          | -                             | 10,557        |
| U.S. government                      | 32,082                       | 120                          | (39)                          | 32,163        |
| Municipal                            | 498,371                      | 15,392                       | (645)                         | 513,118       |
| Total Fixed Income                   | \$ 1,502,504                 | \$ 49,621                    | \$ (6,595)                    | \$ 1,545,530  |
| Equity                               | \$ 214,239                   | \$ 205,253                   | \$ (470)                      | \$ 419,022    |
| Available-for-sale<br>(in thousands) |                              |                              |                               |               |
|                                      | 12/31/2013                   |                              |                               |               |
| Asset Class                          | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. agency                          | \$ 10,513                    | \$ 22                        | \$ (237)                      | \$ 10,298     |
| Corporate                            | 511,748                      | 22,302                       | (8,012)                       | 526,038       |
| Mtge/ABS/CMBS*                       | 350,187                      | 8,188                        | (7,650)                       | 350,725       |
| Non-U.S. govt. & agency              | 13,306                       | 437                          | (65)                          | 13,678        |
| U.S. government                      | 17,086                       | 217                          | -                             | 17,303        |
| Municipal                            | 528,209                      | 6,495                        | (12,694)                      | 522,010       |
| Total Fixed Income                   | \$ 1,431,049                 | \$ 37,661                    | \$ (28,658)                   | \$ 1,440,052  |
| Equity                               | \$ 218,848                   | \$ 200,081                   | \$ (275)                      | \$ 418,654    |

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\*Mortgage-backed, asset-backed and commercial mortgage-backed

The following table presents the amortized cost and fair value of available-for-sale debt securities by contractual maturity dates as of September 30, 2014:

| AFS<br>(in thousands)                 | 9/30/2014<br>Amortized<br>Cost | Fair<br>Value |
|---------------------------------------|--------------------------------|---------------|
| Due in one year or less               | \$ 17,680                      | \$ 17,855     |
| Due after one year through five years | 242,863                        | 253,882       |
| Due after five years through 10 years | 594,841                        | 612,167       |
| Due after 10 years                    | 254,433                        | 262,606       |
| Mtge/ABS/CMBS*                        | 392,687                        | 399,020       |
| Total available-for-sale              | \$ 1,502,504                   | \$ 1,545,530  |

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\*Mortgage-backed, asset-backed and commercial mortgage-backed

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Held-to-Maturity Debt Securities

The carrying value and fair value of held-to-maturity securities was \$0.7 million at September 30, 2014 and December 31, 2013. 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. Unrecognized gains on our held-to-maturity securities were less than \$0.1 million at September 30, 2014 and December 31, 2013. As of September 30, 2014, the carrying value and fair value of all debt securities held-to-maturity had a contractual maturity date of less than one year.

Unrealized Losses

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, 2014 and December 31, 2013. 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, 2014 unrealized losses, as shown in the following tables, were 0.3 percent of total invested assets. Unrealized losses decreased in 2014, as interest rates declined during the first three quarters of the year.

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| (in thousands)                | September 30, 2014 |                      |            | December 31, 2013 |                      |             |
|-------------------------------|--------------------|----------------------|------------|-------------------|----------------------|-------------|
|                               | < 12 Mos.          | 12 Mos. &<br>Greater | Total      | < 12 Mos.         | 12 Mos. &<br>Greater | Total       |
| <b>U.S. Government</b>        |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 18,556          | \$ —                 | \$ 18,556  | \$ —              | \$ —                 | \$ —        |
| Cost or amortized cost        | 18,595             | —                    | 18,595     | —                 | —                    | —           |
| Unrealized Loss               | \$ (39)            | \$ —                 | \$ (39)    | \$ —              | \$ —                 | \$ —        |
| <b>U.S. Agency</b>            |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 1,871           | \$ —                 | \$ 1,871   | \$ 5,760          | \$ —                 | \$ 5,760    |
| Cost or amortized cost        | 1,885              | —                    | 1,885      | 5,997             | —                    | 5,997       |
| Unrealized Loss               | \$ (14)            | \$ —                 | \$ (14)    | \$ (237)          | \$ —                 | \$ (237)    |
| <b>Non-U.S. government</b>    |                    |                      |            |                   |                      |             |
| Fair value                    | \$ —               | \$ —                 | \$ —       | \$ 1,825          | \$ —                 | \$ 1,825    |
| Cost or amortized cost        | —                  | —                    | —          | 1,890             | —                    | 1,890       |
| Unrealized Loss               | \$ —               | \$ —                 | \$ —       | \$ (65)           | \$ —                 | \$ (65)     |
| <b>Mortgage-backed</b>        |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 27,741          | \$ 70,754            | \$ 98,495  | \$ 118,283        | \$ —                 | \$ 118,283  |
| Cost or amortized cost        | 27,848             | 73,223               | 101,071    | 124,034           | —                    | 124,034     |
| Unrealized Loss               | \$ (107)           | \$ (2,469)           | \$ (2,576) | \$ (5,751)        | \$ —                 | \$ (5,751)  |
| <b>ABS/CMBS*</b>              |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 46,758          | \$ 19,100            | \$ 65,858  | \$ 54,115         | \$ —                 | \$ 54,115   |
| Cost or amortized cost        | 47,038             | 19,538               | 66,576     | 56,014            | —                    | 56,014      |
| Unrealized Loss               | \$ (280)           | \$ (438)             | \$ (718)   | \$ (1,899)        | \$ —                 | \$ (1,899)  |
| <b>Corporate</b>              |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 157,718         | \$ 22,591            | \$ 180,309 | \$ 190,470        | \$ 2,245             | \$ 192,715  |
| Cost or amortized cost        | 159,729            | 23,183               | 182,912    | 198,250           | 2,477                | 200,727     |
| Unrealized Loss               | \$ (2,011)         | \$ (592)             | \$ (2,603) | \$ (7,780)        | \$ (232)             | \$ (8,012)  |
| <b>Municipal</b>              |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 30,321          | \$ 49,615            | \$ 79,936  | \$ 309,407        | \$ 943               | \$ 310,350  |
| Cost or amortized cost        | 30,378             | 50,203               | 80,581     | 322,095           | 949                  | 323,044     |
| Unrealized Loss               | \$ (57)            | \$ (588)             | \$ (645)   | \$ (12,688)       | \$ (6)               | \$ (12,694) |
| <b>Subtotal, fixed income</b> |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 282,965         | \$ 162,060           | \$ 445,025 | \$ 679,860        | \$ 3,188             | \$ 683,048  |
| Cost or amortized cost        | 285,473            | 166,147              | 451,620    | 708,280           | 3,426                | 711,706     |
| Unrealized Loss               | \$ (2,508)         | \$ (4,087)           | \$ (6,595) | \$ (28,420)       | \$ (238)             | \$ (28,658) |

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|                        |            |            |            |             |          |             |
|------------------------|------------|------------|------------|-------------|----------|-------------|
| Equity securities      |            |            |            |             |          |             |
| Fair value             | \$ 11,635  | \$ —       | \$ 11,635  | \$ 2,394    | \$ —     | \$ 2,394    |
| Cost or amortized cost | 12,105     | —          | 12,105     | 2,669       | —        | 2,669       |
| Unrealized Loss        | \$ (470)   | \$ —       | \$ (470)   | \$ (275)    | \$ —     | \$ (275)    |
| Total                  |            |            |            |             |          |             |
| Fair value             | \$ 294,600 | \$ 162,060 | \$ 456,660 | \$ 682,254  | \$ 3,188 | \$ 685,442  |
| Cost or amortized cost | 297,578    | 166,147    | 463,725    | 710,949     | 3,426    | 714,375     |
| Unrealized Loss        | \$ (2,978) | \$ (4,087) | \$ (7,065) | \$ (28,695) | \$ (238) | \$ (28,933) |

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\* Asset-backed and commercial mortgage-backed

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The following table shows the composition of the fixed income securities in unrealized loss positions at September 30, 2014 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<br>Rating | Equivalent<br>S&P<br>Rating | Equivalent<br>Moody's<br>Rating | (dollars in thousands) |            | Unrealized<br>Loss | Percent<br>to Total |   |
|----------------|-----------------------------|---------------------------------|------------------------|------------|--------------------|---------------------|---|
|                |                             |                                 | Amortized<br>Cost      | Fair Value |                    |                     |   |
| 1              | AAA/AA/A                    | Aaa/Aa/A                        | \$ 354,379             | \$ 349,481 | \$ (4,898)         | 74.3                | % |
| 2              | BBB                         | Baa                             | 37,566                 | 37,081     | (485)              | 7.4                 | % |
| 3              | BB                          | Ba                              | 35,807                 | 35,139     | (668)              | 10.1                | % |
| 4              | B                           | B                               | 22,598                 | 22,120     | (478)              | 7.2                 | % |
| 5              | CCC or lower                | Caa or lower                    | 1,270                  | 1,204      | (66)               | 1.0                 | % |
| 6              |                             |                                 | —                      | —          | —                  | —                   |   |
|                |                             | Total                           | \$ 451,620             | \$ 445,025 | \$ (6,595)         | 100.0               | % |

## Other Invested Assets

Other invested assets shown on the balance sheet as of September 30, 2014 include an investment in a low income housing tax credit partnership as well as membership in the Federal Home Loan Bank Chicago (FHLBC). During the third quarter of 2014, we recorded an interest in a low income housing tax credit partnership totaling \$10.0 million. The interest had a balance of \$9.9 million at September 30, 2014 and recognized a total tax benefit of \$0.1 million during the quarter. Our investment in FHLBC stock totaled \$1.8 million at the end of the third quarter.

## Cash and Short-term Investments

Cash consists of uninvested balances in bank accounts. We had a cash balance of \$77.0 million at the end of the third quarter of 2014, compared to \$39.5 million at the end of 2013. Short-term investments are carried at cost, which approximates fair value. The balance at September 30, 2014 was \$10.1 million compared to \$23.2 million at December 31, 2013.

## Evaluating Investments for OTTI



The fixed income portfolio contained 290 securities in an unrealized loss position as of September 30, 2014. The \$6.6 million in associated unrealized losses for these 290 securities represents 0.4 percent of the fixed income portfolio's cost basis. Of these 290 securities, 74 have been in an unrealized loss position for 12 consecutive months or longer. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. 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 is recognized in net earnings, with the non-credit related impairment recognized in comprehensive earnings. Based on our analysis, our fixed income portfolio is of high credit quality and we believe we will recover the amortized cost basis of our fixed income 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, 2014, we held three common stock securities that were in an unrealized loss position. The unrealized loss on these securities was \$0.5 million. Based on our analysis, we believe each security will recover in a reasonable period of time and we have the intent and ability to hold them until recovery. No equity securities have been in an unrealized loss position for 12 consecutive months or longer. There were no OTTI losses recognized in the periods presented on the equity portfolio.

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3. FAIR VALUE MEASUREMENTS

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

Fair value is defined as the price in the principal market that would be received for an asset to facilitate an orderly transaction between market participants on the measurement date.

We determined the fair value of certain financial instruments based on their underlying characteristics and relevant transactions in the marketplace. 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.

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 widely recognized, third-party pricing sources to determine our fair values. We have obtained an understanding of the third-party pricing sources' 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, Government and Municipal Bonds: The pricing vendor employs a multi-dimensional 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. All bonds valued using these techniques are classified as Level 2. All corporate, agency, government and municipal securities were deemed Level 2.

Mortgage-backed Securities (MBS)/Commercial Mortgage-backed Securities (CMBS) and Asset-backed Securities (ABS): The pricing vendor evaluation methodology includes principally interest rate movements and new issue 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 MBS and CMBS volatility, an option adjusted spread 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/CMBS and ABS with corroborated, observable inputs are classified as Level 2. All of our MBS/CMBS 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 described above, we periodically conduct a review to assess the reasonableness of the fair values provided by our pricing services. Our review consists of a two pronged approach. First, we compare prices provided by our pricing services to those provided by an additional source. Second, we obtain prices from securities brokers and compare them to the prices provided by our pricing services. In both comparisons, when discrepancies are

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found, we compare our prices to actual reported trade data for like securities. Based on this assessment, we determined that the fair values of our Level 2 securities provided by our pricing services are reasonable.

For common stock, we receive prices from a nationally recognized pricing service. 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 service 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:

| (in thousands)                      | As of September 30, 2014   |   |   | Total        |
|-------------------------------------|--|---|---|--------------|
|                                     | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |              |
| Total trading securities            | \$ —   | \$ —                                    | \$ —                                      | \$ —         |
| Available-for-sale securities       |  |   |   |              |
| U.S. agency                         | \$ —   | \$ 6,516                                | \$ —                                      | \$ 6,516     |
| Corporate                           | —  | 584,156                                 | —   | 584,156      |
| Mortgage-backed                     | —  | 260,902                                 | —   | 260,902      |
| ABS/CMBS*                           | —  | 138,118                                 | —   | 138,118      |
| Non-U.S. govt. & agency             | —  | 10,557                                  | —   | 10,557       |
| U.S. government                     | —  | 32,163                                  | —   | 32,163       |
| Municipal                           | —  | 513,118                                 | —   | 513,118      |
| Equity                              | 419,022  | —                                       | —   | 419,022      |
| Total available-for-sale securities | \$ 419,022   | \$ 1,545,530                            | \$ —                                      | \$ 1,964,552 |
| Total                               | \$ 419,022   | \$ 1,545,530                            | \$ —                                      | \$ 1,964,552 |

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\*Asset-backed and commercial mortgage-backed

| (in thousands)                      | As of December 31, 2013  |   |   | Total        |
|-------------------------------------|--|---|---|--------------|
|                                     | Fair Value Measurements Using                                  |   |   |              |
|                                     | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |              |
| Total trading securities            | \$ —   | \$ —                                    | \$ —                                      | \$ —         |
| Available-for-sale securities       |  |   |   |              |
| U.S. agency                         | \$ —   | \$ 10,298                               | \$ —                                      | \$ 10,298    |
| Corporate                           | —  | 526,038                                 | —   | 526,038      |
| Mortgage-backed                     | —  | 244,416                                 | —   | 244,416      |
| ABS/CMBS*                           | —  | 106,309                                 | —   | 106,309      |
| Non-U.S. govt. & agency             | —  | 13,678                                  | —   | 13,678       |
| U.S. government                     | —  | 17,303                                  | —   | 17,303       |
| Municipal                           | —  | 522,010                                 | —   | 522,010      |
| Equity                              | 418,654  | —                                       | —   | 418,654      |
| Total available-for-sale securities | \$ 418,654   | \$ 1,440,052                            | \$ —                                      | \$ 1,858,706 |
| Total                               | \$ 418,654   | \$ 1,440,052                            | \$ —                                      | \$ 1,858,706 |

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\*Asset-backed and commercial mortgage-backed

As noted in the above table, we did 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 nine-month period ended September 30, 2014.

#### 4. STOCK BASED COMPENSATION

Our RLI Corp. Omnibus Stock Plan (omnibus plan) was in place from 2005 to 2010. The omnibus plan provided for equity-based compensation, including stock options, up to a maximum of 3,000,000 shares of common stock (subject to adjustment for changes in our capitalization and other events). Between 2005 and 2010, we granted 2,457,644 stock options under this plan, including incentive stock options (ISOs), which were adjusted as part of the special dividends paid in 2013 and prior years.

During the second quarter of 2010, our shareholders approved the RLI Corp. Long-Term Incentive Plan (LTIP), which provides for equity-based compensation and replaced the omnibus plan. In conjunction with the adoption of the LTIP, effective May 6, 2010, options were no longer granted under the omnibus plan. Awards under the LTIP may be in the form of restricted stock, stock options (non-qualified 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 maximum number of shares of common stock available for distribution under the LTIP is 4,000,000 shares (subject to adjustment for changes in our capitalization and other events). Since 2010, we have granted 2,777,000 stock options under the LTIP, including 464,500 thus far in 2014.

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 and expire eight years after grant.

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, 2014 and 2013:

|   | 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, 2014    | 2,595,084                           | \$ 26.04                                 |   |   |
| Options granted                           | 464,500                             | \$ 42.90                                 |   |   |
| Options exercised                         | (47,412)                            | \$ 17.95                                 |   | \$ 1,250                                      |
| Options canceled/forfeited                | (740)                               | \$ 16.51                                 |   |   |
| Outstanding options at September 30, 2014 | 3,011,432                           | \$ 28.77                                 | 5.25  | \$ 43,850                                     |
| Exercisable options at September 30, 2014 | 1,351,312                           | \$ 22.29                                 | 3.99  | \$ 28,382                                     |

|   | 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, 2013    | 2,945,204                           | \$ 22.23                                 |   |   |
| Options granted                           | 582,200                             | \$ 36.31                                 |   |   |
| Options exercised                         | (761,362)                           | \$ 17.18                                 |   | \$ 17,211                                     |
| Options canceled/forfeited                | (44,880)                            | \$ 25.93                                 |   |   |
| Outstanding options at September 30, 2013 | 2,721,162                           | \$ 26.59                                 | 5.65  | \$ 46,590                                     |
| Exercisable options at September 30, 2013 | 1,060,662                           | \$ 21.09                                 | 4.35  | \$ 23,995                                     |

The majority of our stock options are granted annually at our regular board meeting in May. In addition, options are approved at the May meeting for quarterly grants to certain retirement eligible employees. Since stock option grants to retirement eligible employees are fully expensed when issued, the approach allows for a more even expense distribution throughout the year.

Thus far in 2014, 464,500 stock options were granted with a weighted average exercise price of \$42.90 and a weighted average fair value of \$7.76. We recognized \$0.9 million of expense in the third quarter of 2014, and \$2.9 million in the first nine months of 2014, related to options vesting. Since options granted under our LTIP are non-qualified, we recorded a tax benefit of \$0.3 million in the third quarter of 2014, and \$1.0 million in the first nine months of 2014, related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$5.2 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 2013, and \$2.8 million of expense in the first nine months of

2013. We recorded a tax benefit of \$0.3 million in the third quarter of 2013, and \$1.0 million in the first nine months of 2013, related to this compensation expense.

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:

|                                       | 2014       | 2013       |
|---------------------------------------|------------|------------|
| Weighted-average fair value of grants | \$ 7.76    | \$ 6.58    |
| Risk-free interest rates              | 1.70 %     | 0.80 %     |
| Dividend yield                        | 1.94 %     | 2.00 %     |
| Expected volatility                   | 23.19 %    | 25.41 %    |
| Expected option life                  | 5.17 years | 5.23 years |

The risk-free rate was determined based on U.S. treasury yields that most closely approximated the option's expected life. The dividend yield was calculated based on the average annualized dividends paid during the most recent five-year period. It excluded the special dividends paid in the fourth quarters of 2013 and prior years. The expected volatility was calculated based on the median of the rolling volatilities for the expected life of the options. In previous years, expected volatility was calculated based on the mean reversion of RLI's stock. The expected option life was determined based on historical



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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.

In 2013 and 2014, each outside director received \$10,000 worth of restricted common shares as part of annual director compensation. The shares were issued annually from the LTIP during the first quarter of each year. The shares were directly owned by each director on the date of issuance and included a one-year restriction on the sale or transfer of such shares. In the first quarter of 2014, we issued a total of 2,097 restricted shares and recognized \$0.1 million of compensation expense. This restricted share program has been terminated and no further restricted shares will be issued going forward.

## 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 |            |
|------------------------------------|--|------------|---|------------|
|                                    | 2014   | 2013       | 2014  | 2013       |
| Net premiums earned:               |  |            |   |            |
| Casualty                           | \$ 96,181  | \$ 83,966  | \$ 281,518  | \$ 235,307 |
| Property                           | 54,143   | 52,705     | 146,252   | 147,305    |
| Surety                             | 27,423   | 27,031     | 79,713  | 79,794     |
| Segment totals before income taxes | \$ 177,747   | \$ 163,702 | \$ 507,483  | \$ 462,406 |
| Net investment income              | 14,200   | 13,598     | 41,764  | 39,331     |
| Net realized gains                 | 5,708  | 10,999     | 22,640  | 18,425     |
| Total consolidated revenue         | \$ 197,655   | \$ 188,299 | \$ 571,887  | \$ 520,162 |
|                                    | NET EARNINGS   |            | NET EARNINGS  |            |
|                                    | 2014   | 2013       | 2014  | 2013       |

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|  |           |           |            |            |
|--|-----------|-----------|------------|------------|
| Casualty                                       | \$ 13,786 | \$ 20,799 | \$ 36,331  | \$ 39,517  |
| Property                                       | 7,498     | 6,468     | 19,469     | 19,614     |
| Surety   | 9,144     | 4,551     | 23,729     | 18,044     |
| Net underwriting income                        | \$ 30,428 | \$ 31,818 | \$ 79,529  | \$ 77,175  |
| Net investment income                          | 14,200    | 13,598    | 41,764     | 39,331     |
| Net realized gains                             | 5,708     | 10,999    | 22,640     | 18,425     |
| General corporate expense and interest on debt | (4,657)   | (3,670)   | (13,129)   | (10,773)   |
| Equity in earnings of unconsolidated investees | 2,915     | 2,564     | 12,204     | 10,696     |
| Total earnings before income taxes             | \$ 48,594 | \$ 55,309 | \$ 143,008 | \$ 134,854 |
| Income tax expense                             | 15,340    | 17,662    | 45,060     | 42,458     |
| Total net earnings                             | \$ 33,254 | \$ 37,647 | \$ 97,948  | \$ 92,396  |

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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, |            |
|----------------------------------|--|-----------|---|------------|
|                                  | 2014   | 2013      | 2014  | 2013       |
| <b>Casualty</b>                  |  |           |   |            |
| Commercial and personal umbrella | \$ 25,256  | \$ 22,247 | \$ 75,036   | \$ 61,803  |
| General liability                | 20,095   | 20,342    | 60,550  | 61,139     |
| Commercial transportation        | 14,677   | 13,463    | 44,193  | 35,594     |
| Professional services            | 15,227   | 11,021    | 41,927  | 30,092     |
| P&C package business             | 8,969  | 7,643     | 25,747  | 22,671     |
| Executive products               | 4,760  | 4,933     | 14,165  | 14,300     |
| Medical professional liability   | 3,546  | 2,674     | 10,970  | 5,136      |
| Other casualty                   | 3,651  | 1,643     | 8,930   | 4,572      |
| Total                            | \$ 96,181  | \$ 83,966 | \$ 281,518  | \$ 235,307 |
| <b>Property</b>                  |  |           |   |            |
| Commercial property              | \$ 20,188  | \$ 18,938 | \$ 60,675   | \$ 57,813  |
| Marine                           | 12,115   | 14,242    | 37,278  | 43,898     |
| Crop reinsurance                 | 11,802   | 11,846    | 18,671  | 19,501     |
| Property reinsurance             | 2,997  | 2,848     | 9,745   | 12,503     |
| Other property                   | 7,041  | 4,831     | 19,883  | 13,590     |
| Total                            | \$ 54,143  | \$ 52,705 | \$ 146,252  | \$ 147,305 |
| <b>Surety</b>                    |  |           |   |            |
| Miscellaneous                    | \$ 9,868   | \$ 9,590  | \$ 28,948   | \$ 28,559  |
| Contract                         | 6,879  | 7,025     | 19,896  | 20,137     |
| Commercial                       | 6,521  | 5,857     | 18,968  | 17,285     |
| Oil and Gas                      | 4,155  | 4,559     | 11,901  | 13,813     |
| Total                            | \$ 27,423  | \$ 27,031 | \$ 79,713   | \$ 79,794  |

|             |            |            |            |            |
|-------------|------------|------------|------------|------------|
| Grand Total | \$ 177,747 | \$ 163,702 | \$ 507,483 | \$ 462,406 |
|-------------|------------|------------|------------|------------|

## 6. ACQUISITION

On February 5, 2014, we invested \$5.3 million for a 20 percent equity ownership interest in Prime Holdings Insurance Services, Inc. (Prime), an Illinois domiciled insurance carrier based in Salt Lake City, Utah. Prime is a privately-held excess and surplus lines insurance company operating in 49 states through a network of wholesale brokers and specializing in hard-to-place risks. The investment in Prime is reflected on our balance sheet as an investment in unconsolidated investee. Under the equity method of accounting we recognize our proportionate share of Prime's income as equity in earnings of unconsolidated investees. Our share of Prime's earnings amounted to \$0.1 million in the third quarter of 2014 and \$0.4 million in the first nine months of 2014.

Additionally, we entered into a 25 percent quota share reinsurance treaty with Prime, effective January 1, 2014. We assumed gross premiums of \$2.4 million related to this quota share agreement in the third quarter of 2014 and \$7.4 million in the first nine months of 2014.

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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, 2013.

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. These companies are organized in a vertical structure beneath RLI Corp. with RLI Insurance Company (RLI Ins.) as the first-level, or principal, insurance subsidiary. RLI Ins. writes multiple lines of insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company (Mt. Hawley), a subsidiary of RLI Ins., writes excess and surplus lines insurance on a non-admitted basis in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company (RIC), a subsidiary of Mt. Hawley, has authority to write multiple lines of insurance on an admitted basis in 48 states and the District of Columbia. Contractors Bonding and Insurance Company (CBIC), a subsidiary of RLI Ins., has authority to write multiple lines of insurance on an admitted basis in all 50 states and the District of Columbia. Each of our insurance companies is domiciled in Illinois, with the exception of CBIC, which is domiciled in Washington. We are an Illinois corporation that was organized in 1965.

As a specialty company with a niche focus, we offer insurance coverages in both the specialty admitted and excess and surplus markets. Coverages in the specialty admitted market, such as our oil and gas surety bonds, are for risks that are unique or hard-to-place in the standard market, but must remain with an admitted insurance company for regulatory or marketing reasons. In addition, our coverages in the specialty admitted market may be designed to meet specific insurance needs of targeted insured groups, such as our professional liability and package coverages for design professionals and our stand-alone personal umbrella policy. The specialty admitted market is subject to more state regulation than the excess and surplus market, particularly with regard to rate and form filing requirements, restrictions on the ability to exit lines of business, premium tax payments and membership in various state associations, such as state guaranty funds and assigned risk plans. We also underwrite coverages in the excess and surplus market. The excess and surplus market, unlike the standard admitted market, is less regulated and more flexible in terms of policy forms and premium rates. This market provides an alternative for customers with risks or loss exposures that generally cannot be written in the standard admitted market. This typically results in coverages that are more restrictive and more expensive than coverages in the standard admitted market. When we underwrite within the excess and surplus 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

effectively. Often, the development of these coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients or loss exposures. 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 18 consecutive years, averaging an 87.6 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 monitor our investment risks. Despite periodic fluctuations in market value, our equity portfolio is part of a long-term asset allocation strategy and has contributed significantly to our historic growth in book value.

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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 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 and commercial umbrella coverages, as well as package business and other specialty coverages, such as professional liability and workers compensation for office-based professionals. We offer fidelity and crime coverage for commercial insureds and select financial institutions and recently expanded our casualty offerings to include medical professional liability coverage in the excess and surplus market. We also assume select casualty business written by Prime under a reinsurance treaty. 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, and facultative and treaty reinsurance including crop. We also offer select personal lines policies, such as recreational vehicle and Hawaii homeowners coverages. While our marine and facultative reinsurance coverages are predominantly domestic risks, these portfolios do contain a relatively small portion of foreign risks. 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 maintaining policy terms and conditions throughout market cycles. We also use computer-assisted modeling techniques to 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 typically maintain 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 the deterioration of a contractor's financial condition. This line has historically produced marginally higher loss ratios than other surety lines during economic downturns.

Rates increased moderately on most coverages through 2013, a year in which abnormally low catastrophe activity led to improved financial results across the industry. This led to softer reinsurance pricing in the first nine months of 2014, which will likely impact primary rates for the remainder of the year. As a result, the insurance marketplace remains intensely competitive. Despite these competitive pressures, we believe that our business model is built to create underwriting income by focusing on sound risk selection and discipline. Our primary focus will continue to be on underwriting profitability, with a secondary focus on premium growth where we believe underwriting profit exists, as opposed to general premium growth or market share measurements.



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In the third quarter of 2014, we received provisional notice of cancellation on the largest portion of our assumed crop business along with notice of a 50 percent reduction on our remaining coverage. While the cancellations are expected to reduce top line premium to less than \$10 million in 2015 from \$50 million through the third quarter 2014, the impact on underwriting income is expected to be minimal.

## 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 in our 2013 Annual Report on Form 10-K, 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 earnings from unconsolidated investees.

### 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 interim 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. For a detailed discussion of each of these policies, refer to our 2013 Annual Report on Form 10-K. There have been no significant changes to any of these policies during the current year.

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## NINE MONTHS ENDED SEPTEMBER 30, 2014 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2013

Consolidated revenues, as displayed in the table that follows, totaled \$571.9 million for the first nine months of 2014 compared to \$520.2 million for the same period in 2013.

|                                      | For the Nine-Month Periods<br>Ended September 30, |            |
|--------------------------------------|---|------------|
|                                      | 2014  | 2013       |
| Consolidated revenues (in thousands) |   |            |
| Net premiums earned                  | \$ 507,483  | \$ 462,406 |
| Net investment income                | 41,764  | 39,331     |
| Net realized investment gains        | 22,640  | 18,425     |
| Total consolidated revenue           | \$ 571,887  | \$ 520,162 |

Consolidated revenue for the first nine months of 2014 increased \$51.7 million, or 10 percent, from the same period in 2013. Net premiums earned for the Group increased 10 percent, led by growth in our casualty segment which was up 20 percent. Net premiums earned from our surety and property segments declined slightly from the prior year. Net investment income increased 6 percent to \$41.8 million due to a larger invested asset base and reinvestment rates that remain near the average yield of the portfolio. We realized net investment gains of \$22.6 million in the first nine months of 2014, compared to \$18.4 million during the same period of 2013.

Net after-tax earnings for the first nine months of 2014 totaled \$97.9 million, \$2.24 per diluted share, compared to \$92.4 million, \$2.13 per diluted share, for the same period in 2013. In 2014, favorable development on prior years' loss and catastrophe reserves resulted in additional pretax earnings of \$60.3 million. Partially offsetting this favorable development was \$1.3 million of reinsurance reinstatement premium related to unfavorable development on prior years' surety reserves. From a comparative standpoint, results for 2013 included favorable development on prior years' loss and catastrophe reserves which resulted in additional pretax earnings of \$63.4 million. In addition, losses from spring storms impacted results for both periods, with losses totaling \$7.3 million in the first nine months of 2014 compared to \$10.0 million for the same period last year. Hurricane Iselle and the American Canyon Earthquake were non-events from a loss standpoint on the 2014 accident year, impacting results by less than \$0.5 million. Bonus and profit sharing-related expenses associated with these specific items totaled \$7.4 million in 2014, compared to \$7.3 million in 2013. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonus and profit-sharing amounts earned by executives, managers and associates are predominately influenced by corporate performance including operating earnings, combined ratio and return on capital.

During the first nine months of 2014, equity in earnings of unconsolidated investees totaled \$12.2 million. This amount includes \$11.8 million from Maui Jim and \$0.4 million from Prime Holdings Insurance Services, Inc. (Prime). Refer to Note 6, Acquisitions, for more information regarding our February 2014 investment in Prime. Comparatively, the first nine months of 2013 reflected \$10.7 million of Maui Jim earnings.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses, net of tax), was \$123.3 million, \$2.82 per diluted share, for the first nine months of 2014, compared to \$74.5 million, \$1.72 per diluted share, for the same period last year. Unrealized gains, net of tax, for the first nine months of 2014 were \$25.3 million, compared to unrealized losses, net of tax, of \$17.9 million for the same period in 2013. Unrealized gains in the current year were largely from the fixed income portfolio, as interest rates declined during the first three quarters of 2014.

#### RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group increased 3 percent to \$669.4 million for the first nine months of 2014. Our casualty and surety segments each showed growth, up 6 percent and 3 percent, respectively, which offset a 3 percent decline from the property segment. Expansion efforts and new product initiatives have contributed to the overall growth in premiums, as production has increased despite heightened competition in the marketplace. From a pricing standpoint, trends seen during the current year have varied across our product portfolio. The positive pricing momentum seen within our casualty segment during the prior year has largely slowed, while rates on

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most surety products and property coverages have remained flat or declined. Net premiums written advanced 6 percent in the first nine months of 2014, and outpaced growth in gross premiums written due largely to cost savings realized on our 2014 reinsurance renewals. During the first half of 2014, we renewed all material reinsurance treaties which resulted in over \$16.0 million of annual savings. Reinsurance structures are largely unchanged with the exception of surety, where we purchased additional limit, and professional liability for office-based professionals, where we increased our retention. On a net premiums earned basis, premiums increased \$45.0 million, or 10 percent, due to overall growth experienced in recent periods and increased retentions in 2013 on certain casualty products. The casualty segment has contributed significantly to this growth, with net premiums written up 10 percent, and net premiums earned up 20 percent from the first nine months of last year. Underwriting income for the Group totaled \$79.5 million for the first nine months of 2014, compared to \$77.2 million in 2013. Both periods benefited from favorable development on prior years' loss and catastrophe reserves, though the benefit in 2014 was \$3.3 million lower than the prior year. Spring storm losses also impacted results for each period, with \$6.2 million and \$8.8 million recognized in 2014 and 2013, respectively. The GAAP combined ratio totaled 84.3 in 2014, compared to 83.3 in 2013. The Group's loss ratio increased to 43.4, from 41.4, while the Group's expense ratio improved one point to 40.9.

|                                       | For the Nine-Month Periods<br>Ended September 30, |            |
|---------------------------------------|---|------------|
|                                       | 2014  | 2013       |
| Gross premiums written (in thousands) |   |            |
| Casualty                              | \$ 364,027  | \$ 343,179 |
| Property                              | 216,499   | 222,190    |
| Surety                                | 88,864  | 86,129     |
| Total                                 | \$ 669,390  | \$ 651,498 |
| Underwriting income (in thousands)    |   |            |
| Casualty                              | \$ 36,331   | \$ 39,517  |
| Property                              | 19,469  | 19,614     |
| Surety                                | 23,729  | 18,044     |
| Total                                 | \$ 79,529   | \$ 77,175  |
| Combined ratio                        |   |            |
| Casualty                              | 87.1  | 83.2       |
| Property                              | 86.7  | 86.6       |
| Surety                                | 70.2  | 77.4       |
| Total                                 | 84.3  | 83.3       |

## Casualty

Gross premiums written for the casualty segment totaled \$364.0 million for the first nine months of 2014, an increase of \$20.8 million, or 6 percent, from the same period last year. A majority of the products within this segment,

including both mature products and newer product initiatives, have contributed to this growth, aided by modest rate increases on select lines. On an overall basis, however, pricing momentum for the segment has slowed. Our professional services product, which includes offerings to architects and engineers, posted gross premiums written of \$55.5 million, up \$11.8 million, or 27 percent, from the first nine months of 2013. Our P&C package business delivered solid results, with gross premiums written growth of 11 percent, while other notable contributions included umbrella, up \$2.0 million (2 percent) and security guards coverage, up \$1.1 million (49 percent). Our new assumed casualty reinsurance business posted premiums of \$7.4 million in the first nine months of 2014. This business relates to the reinsurance agreement which accompanied our minority investment in Prime. On an annual basis, we expect to assume premiums of \$8 million to \$10 million from this reinsurance treaty. Gross premiums written by general liability were flat, while transportation was down \$4.6 million or 7 percent. The decline in transportation follows a 72 percent increase achieved during the comparable period of 2013.

The casualty segment recorded underwriting income of \$36.3 million for the first nine months of 2014, compared to \$39.5 million for the same period last year. Results for both periods included favorable development on prior years' loss and catastrophe reserves. Products with favorable development in 2014 included general liability, umbrella, P&C package, transportation, professional services and executive products. From an accident year standpoint, the majority of the favorable development occurred on the 2006 through 2013 accident years, with the more recent years accounting for

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a larger percentage. Due to positive emergence, during the first nine months of 2014 we released reserves which improved the segment's underwriting results by \$40.5 million. Results were also impacted by spring storms losses, which reduced underwriting income for the segment by \$1.9 million. From a comparative standpoint, 2013 results included favorable development on prior accident years' loss reserves, primarily for general liability, umbrella, P&C package and executive products, which improved the segment's underwriting results by \$46.2 million. Losses from spring storms were minimal, impacting results by \$0.1 million.

Overall, the combined ratio for the casualty segment was 87.1 for 2014 compared to 83.2 in 2013. The segment's loss ratio was 51.6 in 2014 compared to 46.4 in 2013. The increase was driven by the lower reserve releases on prior years' loss and catastrophe reserves in 2014. The expense ratio for the casualty segment was 35.5 for the first nine months of 2014, compared to 36.8 in the prior year, due to improved leveraging of our expense base. Increased retentions elected during the prior year, and cost savings realized during the 2014 reinsurance renewal also contributed to the expense ratio decline.

## Property

Gross premiums written for the Group's property segment totaled \$216.5 million for the first nine months of 2014, a decrease of \$5.7 million, or 3 percent, from the same period last year. Premium production for the segment has declined as a result of action taken to re-underwrite certain underperforming business and continued competitive pressures on rates for E&S property coverages. Our catastrophe-exposed assumed reinsurance programs decreased \$2.7 million, or 20 percent, from the same period last year, as we continued to exit certain underperforming programs within this book. Difference in conditions (DIC) premiums have decreased \$3.0 million as a result of increased competition and lower rates resulting from largely benign catastrophe activity in recent periods. Marine business declined \$6.0 million, or 13 percent, due to re-underwriting efforts, while crop reinsurance premiums were down 3 percent to \$50.3 million. Partially offsetting these decreases, our recreational vehicles program posted \$5.0 million of premium growth. Premiums from our fire and Hawaii homeowners coverages also improved, up 4 percent and 2 percent, respectively.

Underwriting income for the segment was \$19.5 million for the first nine months of 2014, compared to \$19.6 million for the same period in 2013. Results for 2014 were impacted by favorable development on prior years' loss and catastrophe reserves, primarily on marine business, which improved the segment's underwriting results by \$0.8 million. This favorable development was more than offset by losses recorded on 2014 spring storms and the American Canyon Earthquake, which reduced the segment's underwriting results by \$4.5 million. From a comparative standpoint, underwriting results for 2013 included a \$5.4 million benefit from favorable development on prior years' loss and catastrophe reserves, and \$8.7 million in losses on 2013 spring storms.

Segment results for 2014 translated into a combined ratio of 86.7 compared to 86.6 for the same period last year. The segment's loss ratio was 49.0 in 2014 compared to 48.0 in 2013, while the segment's expense ratio was 37.7 for 2014 compared to 38.6 in 2013.

## Surety

The surety segment recorded gross premiums written of \$88.9 million for the first nine months of 2014, an increase of \$2.7 million, or 3 percent, from the same period last year. Premium growth was achieved despite flat pricing across many surety products, which has resulted from ongoing intense competition in this market. Increased construction activity led to \$22.2 million of gross premiums written for commercial surety, up 18 percent, while miscellaneous and contract surety also improved slightly. These increases more than offset a decline from our oil and gas product, which decreased \$2.2 million, or 15 percent.

The surety segment recorded underwriting income of \$23.7 million, compared to \$18.0 million for the same period last year. Solid current accident year results were bolstered by favorable development on prior accident years' loss reserves which improved the segment's underwriting results by \$11.3 million in 2014. This favorable development was partially offset by reinsurance reinstatement premium related to unfavorable development on prior years' surety reserves which reduced underwriting income by \$1.1 million. From a comparative standpoint, 2013 results included favorable loss development which improved the segment's underwriting results by \$4.3 million.

The combined ratio for the surety segment was 70.2 in the first nine months of 2014, versus 77.4 for the same period in 2013. The segment's loss ratio was 4.3 for 2014, compared to 14.3 for 2013, due largely to the increased benefit from



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favorable development in 2014. The expense ratio was 65.9 for 2014, compared to 63.1 in 2013. The increase was a result of the impact of the above-mentioned reinstatement premium, and shifts in mix toward products with higher acquisition expense rates.

## INVESTMENT INCOME AND REALIZED CAPITAL GAINS

During the first nine months of 2014, net investment income increased 6.2 percent from that reported for the same period in 2013. The increase in investment income was due to a larger invested asset base and reinvestment rates that remain near the average yield of the portfolio. On an after-tax basis, investment income increased by 6.6 percent.

| (in thousands)                  | 9/30/2014            |         | 12/31/2013           |         |
|---------------------------------|----------------------|---------|----------------------|---------|
|                                 | Financial Stmt Value | %       | Financial Stmt Value | %       |
| Fixed income                    | \$ 1,546,180         | 74.9 %  | \$ 1,440,703         | 74.9 %  |
| Equity securities               | 419,022              | 20.3 %  | 418,654              | 21.8 %  |
| Other invested assets           | 11,688               | 0.6 %   | —                    | 0.0 %   |
| Cash and short-term investments | 87,100               | 4.2 %   | 62,701               | 3.3 %   |
| Total                           | \$ 2,063,990         | 100.0 % | \$ 1,922,058         | 100.0 % |

Our current equity allocation represents 20 percent 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 yields on our fixed income investments (excluding short-term investments) for the first nine months of 2014 and 2013 were as follows:

|      |      |
|------|------|
| 2014 | 2013 |
|------|------|

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|                 |      |   |      |   |
|-----------------|------|---|------|---|
| Pretax Yield    |      |   |      |   |
| Taxable         | 3.61 | % | 3.67 | % |
| Tax-Exempt      | 2.77 | % | 2.70 | % |
| After-Tax Yield |      |   |      |   |
| Taxable         | 2.35 | % | 2.39 | % |
| Tax-Exempt      | 2.62 | % | 2.56 | % |

The fixed income portfolio increased by \$105.5 million in the first nine months of 2014. The increase is due to allocating the majority of cash flows to the fixed income portfolio. This portfolio had a tax-adjusted total return on a mark-to-market basis of 5.3 percent. Average fixed income duration was 4.6 years at September 30, 2014, reflecting our current liability structure and sound capital position.

The equity portfolio increased by \$0.4 million during the first nine months of 2014, to \$419.0 million, and had a total return of 8.1 percent through September 30, 2014.

We recognized \$22.6 million in realized gains in the first nine months of 2014, compared to realized gains of \$18.4 million in the same period of 2013. Realized gains were primarily derived from equity sales as we rebalanced into fixed income assets. We did not record any realized losses associated with OTTI of securities during the first nine months of 2014.

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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, 2014, including fair value, cost basis and unrealized gains and losses.

| (in thousands)         | 9/30/2014<br>Cost<br>Basis | Fair Value | Unrealized<br>Gains | Losses   | Net        | Unrealized<br>Gain/Loss % (1) |   |
|------------------------|----------------------------|------------|---------------------|----------|------------|-------------------------------|---|
| Consumer discretionary | \$ 15,582                  | \$ 28,772  | \$ 13,190           | \$ —     | \$ 13,190  | 84.6                          | % |
| Consumer staples       | 14,456                     | 36,588     | 22,230              | (98)     | 22,132     | 153.1                         | % |
| Energy                 | 12,521                     | 31,986     | 19,633              | (168)    | 19,465     | 155.5                         | % |
| Financials             | 24,054                     | 44,593     | 20,539              | —        | 20,539     | 85.4                          | % |
| Healthcare             | 7,606                      | 27,203     | 19,597              | —        | 19,597     | 257.7                         | % |
| Industrials            | 19,207                     | 36,961     | 17,754              | —        | 17,754     | 92.4                          | % |
| Information technology | 19,062                     | 34,661     | 15,599              | —        | 15,599     | 81.8                          | % |
| Materials              | 2,249                      | 6,354      | 4,105               | —        | 4,105      | 182.5                         | % |
| Telecommunications     | 8,541                      | 17,281     | 8,740               | —        | 8,740      | 102.3                         | % |
| Utilities              | 36,896                     | 64,281     | 27,385              | —        | 27,385     | 74.2                          | % |
| ETF                    | 54,065                     | 90,342     | 36,481              | (204)    | 36,277     | 67.1                          | % |
|                        | \$ 214,239                 | \$ 419,022 | \$ 205,253          | \$ (470) | \$ 204,783 | 95.6                          | % |

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

## INCOME TAXES

Our effective tax rate was 32 percent for the first nine months of 2014 and 31 percent for the first nine months of 2013. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the first nine months of 2014 was slightly higher than 2013 due to an increase in underwriting income relative to tax favored investment income.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35 percent to pretax income for the first nine months of 2014 and 2013 as a result of the following:

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| (in thousands)  | 2014      |     |   | 2013      |     |   |
|---|-----------|-----|---|-----------|-----|---|
|   | Amount    | %   |   | Amount    | %   |   |
| Provision for income taxes at the Statutory rate of 35% | \$ 50,053 | 35  | % | \$ 47,199 | 35  | % |
| Increase (reduction) in taxes resulting from:           |           |     |   |           |     |   |
| Tax exempt interest income                              | (3,115)   | (2) | % | (2,717)   | (2) | % |
| Dividends received deduction                            | (1,764)   | (1) | % | (1,871)   | (2) | % |
| ESOP dividends paid deduction                           | (639)     | —   | % | (592)     | —   | % |
| Other items, net  | 525       | —   | % | 439       | —   | % |
| Total tax expense                                       | \$ 45,060 | 32  | % | \$ 42,458 | 31  | % |

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## THREE MONTHS ENDED SEPTEMBER 30, 2014 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2013

Consolidated revenues, as displayed in the table that follows, totaled \$197.7 million for the third quarter of 2014 compared to \$188.3 million for the same period in 2013.

|                                      | For the Three-Month Periods<br>Ended September 30, |            |
|--------------------------------------|--|------------|
|                                      | 2014   | 2013       |
| Consolidated revenues (in thousands) |  |            |
| Net premiums earned                  | \$ 177,747   | \$ 163,702 |
| Net investment income                | 14,200   | 13,598     |
| Net realized investment gains        | 5,708  | 10,999     |
| Total consolidated revenue           | \$ 197,655   | \$ 188,299 |

Consolidated revenue for the third quarter of 2014 increased \$9.4 million, or 5 percent, from the same period in 2013. Net premiums earned for the Group increased 9 percent for the quarter, led by growth in our casualty segment, which was up 15 percent. Our property and surety segments also grew, though to a lesser extent, up 3 percent and 1 percent, respectively. Net investment income increased 4 percent to \$14.2 million due to a larger invested asset base and steady reinvestment rates. Net realized investment gains totaled \$5.7 million in the third quarter of 2014, compared to \$11.0 million in 2013.

Net after-tax earnings for the third quarter of 2014 totaled \$33.3 million, \$0.76 per diluted share, compared to \$37.6 million, \$0.86 per diluted share, for the same period in 2013. Both periods reflect favorable current accident year results that were aided by a lack of catastrophe losses. From a prior accident year standpoint, favorable development on prior years' loss and catastrophe reserves resulted in additional pretax earnings of \$18.0 million in the third quarter of 2014. Comparatively, in the third quarter of 2013, favorable development on prior years' loss reserves resulted in additional pretax earnings of \$23.4 million. Bonus and profit sharing-related expenses related to these specific items totaled \$2.8 million in 2014, compared to \$3.7 million in 2013.

During the third quarter of 2014, equity in earnings of unconsolidated investees totaled \$2.9 million. This amount includes \$2.8 million from Maui Jim and \$0.1 million from Prime. Comparatively, the third quarter of 2013 reflected \$2.6 million of Maui Jim earnings. Prior year figures reflect only Maui Jim results, as our equity investment in Prime occurred in the first quarter of 2014.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$20.9 million, \$0.48 per diluted share, for the third quarter of 2014, compared to \$35.7 million, \$0.82 per diluted share, for the third quarter of 2013. Unrealized losses, net of tax, for the third quarter of 2014 were \$12.4 million, compared to \$1.9 million for the same period in 2013. Unrealized losses in the quarter were primarily due to a decline in the equity portfolio during the third quarter of 2014.

#### RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group increased 3 percent to \$207.8 million for the third quarter of 2014 from \$201.7 million in the third quarter of 2013. Growth was achieved in all three segments with casualty up 3 percent, property up 2 percent and surety up 6 percent. Expansion efforts and newer product initiatives across all three segments have contributed to increased premium production. Net premiums written advanced 8 percent in the quarter, outpacing growth in gross premiums written due largely to cost savings realized during our 2014 reinsurance renewals. On a net premiums earned basis, premiums increased \$14.0 million, or 9 percent, overall, led by a 15 percent increase from our casualty segment. The increase resulted from the overall growth experienced in recent periods and increased retentions in 2013 on certain casualty products. Underwriting income for the Group decreased \$1.4 million to \$30.4 million for the third quarter of 2014. Results for 2014 reflect favorable development of \$15.3

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million on prior years' loss and catastrophe reserves, compared to favorable development of \$19.7 million on prior years' loss and catastrophe reserves in 2013. The GAAP combined ratio totaled 82.9 in 2014 and 80.5 in 2013.

|                                       | For the Three-Month Periods<br>Ended September 30, |            |
|---------------------------------------|--|------------|
|                                       | 2014   | 2013       |
| Gross premiums written (in thousands) |  |            |
| Casualty                              | \$ 119,789   | \$ 116,242 |
| Property                              | 56,611   | 55,716     |
| Surety                                | 31,422   | 29,708     |
| Total                                 | \$ 207,822   | \$ 201,666 |
| Underwriting income (in thousands)    |  |            |
| Casualty                              | \$ 13,786  | \$ 20,799  |
| Property                              | 7,498  | 6,468      |
| Surety                                | 9,144  | 4,551      |
| Total                                 | \$ 30,428  | \$ 31,818  |
| Combined ratio                        |  |            |
| Casualty                              | 85.6   | 75.3       |
| Property                              | 86.1   | 87.7       |
| Surety                                | 66.7   | 83.2       |
| Total                                 | 82.9   | 80.5       |

## Casualty

Gross premiums written for the casualty segment increased 3 percent, to \$119.8 million for the third quarter of 2014, as a number of products within the segment have advanced top-line production. While pricing momentum has slowed relative to the improvements seen in the previous year, the rate environment for our casualty products has been more favorable than that of our property and surety coverages. Premium growth was most notable from our professional services group, up \$4.8 million (31 percent), and our P&C package business, which advanced \$1.8 million (20 percent) to \$10.7 million. Umbrella coverages also delivered solid results, with gross premiums written up \$1.2 million (4 percent). Our assumed casualty reinsurance business, which relates to our new quota share reinsurance treaty with Prime, posted \$2.4 million of premium in the quarter. Growth from these products offset a \$6.3 million (27 percent) decline from transportation and a \$1.0 million (27 percent) decline from our medical professional liability business. The decline in transportation follows significant growth in this book over the past two years, including a 61 percent increase achieved during the comparable quarter of 2013.

The casualty segment recorded underwriting income of \$13.8 million in the third quarter of 2014, compared to \$20.8 million for the same period last year. Both periods produced positive underwriting income in the current accident year that were improved by favorable development on prior years' loss and catastrophe reserves. During the third quarter of 2014, we released reserves which improved the segment's underwriting results by \$11.2 million. Products with favorable development included general liability, umbrella, P&C package and transportation. From an accident year standpoint, the majority of the favorable development occurred on more recent accident years (2006-2013). From a comparative standpoint, 2013 results included favorable development on prior accident years' loss reserves, primarily for general liability, umbrella and P&C package, which improved the segment's underwriting results by \$17.5 million.

Overall, the combined ratio for the casualty segment was 85.6 for 2014 compared to 75.3 in 2013. The segment's loss ratio was 49.7 in 2014 compared to 38.5 in 2013. The loss ratio increase was due to the decreased level of favorable development on prior years' reserves in 2014 combined with a slight increase in the current accident year loss ratio. The expense ratio for the casualty segment was 35.9 for the third quarter of 2014 compared to 36.8 for the same period in 2013.

#### Property

Gross premiums written for the Group's property segment totaled \$56.6 million for the third quarter of 2014, a 2 percent increase from the same period last year. Premium production from these coverages continues to be impacted by



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competitive pressures on pricing, and by actions we have taken with respect to certain underperforming products within this book. Our fire and catastrophe-exposed assumed reinsurance programs contributed \$0.9 million and \$0.5 million of growth to gross premiums written respectively. Partially offsetting these increases, our DIC product declined 8 percent from the prior year as a result of increased competition and lower rates resulting from largely benign catastrophe activity in recent periods. Marine premiums also decreased, down 4 percent from the prior year. The decline in marine has slowed relative to that seen in more recent quarters as efforts to re-underwrite this book were largely completed by the end of September.

Underwriting income for the segment was \$7.5 million for the third quarter of 2014, compared to \$6.5 million for the same period in 2013. Both periods benefited from positive underwriting income for the current accident year that were aided by benign catastrophe seasons. Current accident year results for 2014, while profitable on an overall basis, included \$2.3 million in losses related to an increase in the loss booking ratio for our recreational vehicle business. From a prior accident year standpoint, 2014 results were minimally impacted by development on prior years' loss and catastrophe reserves, while 2013 results included favorable development of \$3.1 million.

Segment results for the third quarter of 2014 translate into a combined ratio of 86.1 compared to 87.7 for the same period last year. The segment's loss ratio increased to 51.6 in 2014 from 50.7 in 2013. From an expense standpoint, the segment's expense ratio for the third quarter was 34.5 for 2014, compared to 37.0 in 2013.

Surety

The surety segment recorded gross premiums written of \$31.4 million for the second quarter of 2014, an increase of 6 percent from the same period last year. Increased construction activity led to \$1.4 million of premium growth on our commercial surety line, offsetting a 10 percent decline on our oil and gas surety product.

The surety segment recorded underwriting income of \$9.1 million, compared to \$4.6 million for the same period last year. Results for 2014 included favorable development on prior accident years' loss reserves which improved the segment's underwriting results by \$4.3 million. From a comparative standpoint, 2013 results included favorable development on prior accident years' loss reserves which had a minimal impact on the segment's underwriting results.

The combined ratio for the surety segment totaled 66.7 for the third quarter of 2014, versus 83.2 for the same period in 2013. The segment's loss ratio was 0.9 for 2014, compared to 19.4 for 2013. The loss ratio decrease was due to the combined effect of increased favorable development on prior years' reserves and moderate improvement in the current accident year loss ratio. The expense ratio for the second quarter was 65.8 for 2014, compared to 63.8 in 2013.

## INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net investment income of \$14.2 million during the third quarter of 2014, an increase of 4.4 percent from that reported for the same period in 2013. The increase in investment income was due to a larger invested asset base and steady reinvestment rates. On an after-tax basis, investment income increased by 4.0 percent.

Yields on our fixed income investments for the third quarter of 2014 and 2013 were as follows:

|                 | 3Q 2014 |   | 3Q 2013 |   |
|-----------------|---------|---|---------|---|
| Pretax Yield    |         |   |         |   |
| Taxable         | 3.48    | % | 3.75    | % |
| Tax-Exempt      | 2.81    | % | 2.70    | % |
| After-Tax Yield |         |   |         |   |
| Taxable         | 2.26    | % | 2.44    | % |
| Tax-Exempt      | 2.66    | % | 2.56    | % |

We recognized \$5.7 million in realized gains in the third quarter of 2014, compared to realized gains of \$11.0 million in the third quarter of 2013. Investment gains during the quarter were taken primarily in the equity portfolio as we rebalanced into fixed income assets. We did not record any realized losses associated with OTTI of securities during the third quarter of 2014.

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## INCOME TAXES

Our effective tax rate was 32 percent for the third quarter of 2014 and 2013. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the third quarter of 2014 was the same due to a similar ratio of tax-favored investment income 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 percent to pretax income for the third quarter of 2014 and 2013 as a result of the following:

| (in thousands)  | 2014      |     |   | 2013      |     |   |
|---|-----------|-----|---|-----------|-----|---|
|   | Amount    | %   |   | Amount    | %   |   |
| Provision for income taxes at the Statutory rate of 35% | \$ 17,008 | 35  | % | \$ 19,358 | 35  | % |
| Increase (reduction) in taxes resulting from:           |           |     |   |           |     |   |
| Tax exempt interest income                              | (1,033)   | (2) | % | (991)     | (2) | % |
| Dividends received deduction                            | (633)     | (1) | % | (708)     | (1) | % |
| ESOP dividends paid deduction                           | (218)     | —   | % | (199)     | —   | % |
| Other items, net  | 216       | —   | % | 202       | —   | % |
| Total tax expense                                       | \$ 15,340 | 32  | % | \$ 17,662 | 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 shareholder dividend payments and 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, 2014 and 2013:

|                      | 2014           | 2013        |
|----------------------|----------------|-------------|
|                      | (in thousands) |             |
| Operating cash flows | \$ 85,894      | \$ 81,736   |
| Investing cash flows | \$ (29,607)    | \$ (22,345) |
| Financing cash flows | \$ (18,719)    | \$ (16,307) |
| Total                | \$ 37,568      | \$ 43,084   |

Operating activities generated positive cash flows of \$85.9 million in the first nine months of 2014, compared to \$81.7 million in the same period last year. The increase in operating cash flows is due largely to reduced levels of paid losses relative to the prior year. The majority of cash outflows from investing activities related to purchases of fixed income securities with a focus on an allocation to high yield credit.

We have \$149.6 million in debt outstanding. On October 2, 2013, we completed a public debt offering, issuing \$150.0 million in senior notes maturing September 15, 2023 (a 10-year maturity), and paying interest semi-annually at the rate of 4.875 percent per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$148.6 million. The estimated fair value for the senior note at September 30, 2014 was \$158.7 million. The fair value of our debt is estimated based on the limited observable prices that reflect thinly traded securities.

As of September 30, 2014, we had cash, short-term investments and other investments maturing within one year of approximately \$105.6 million and an additional \$269.8 million maturing between one to five years. As of September 30, 2014, our short-term investments were held primarily in government/agency funds. All funds are NAIC-rated, 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.

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We also maintain a revolving line of credit with JP Morgan Chase Bank N.A., which permits us to borrow up to an aggregate principal amount of \$40.0 million. This facility was entered into during the second quarter of 2014 and replaced the previous \$25.0 million facility which expired on May 31, 2014. Under certain conditions, the line may be increased up to an aggregate principal amount of \$65.0 million. The facility has a four-year term that expires on May 28, 2018. As of and during the quarter ended September 30, 2014 no amounts were outstanding on this facility.

Additionally, during the third quarter of 2014, two of our insurance companies, RLI Ins. and Mt. Hawley, became members of the Federal Home Loan Bank of Chicago (FHLBC). Membership in the Federal Home Loan Bank System will provide both companies access to an additional source of liquidity via a secured lending facility. Our membership allows each insurance subsidiary to determine tenor and structure at the time of borrowing. As of the end of the third quarter, there were no outstanding borrowing amounts with FHLBC.

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 our bank credit facility, FHLBC membership, our highly liquid investment portfolio and 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, 2014, our investment portfolio had a balance sheet value of \$2.1 billion. Invested assets at September 30, 2014, have increased \$141.9 million from December 31, 2013.

As of September 30, 2014, our investment portfolio had the following asset allocation breakdown:

Portfolio Allocation

(in thousands)

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| Asset class                     | Cost or Amortized Cost | Fair Value   | Unrealized Gain/(Loss) | % of Total Fair Value | Quality* |
|---------------------------------|------------------------|--------------|------------------------|-----------------------|----------|
| U.S. agency                     | \$ 6,383               | \$ 6,516     | \$ 133                 | 0.3                   | % AA     |
| Corporate                       | 563,120                | 584,156      | 21,036                 | 28.3                  | % BBB    |
| Mortgage-backed                 | 255,382                | 260,902      | 5,520                  | 12.6                  | % AA     |
| ABS/CMBS**                      | 137,305                | 138,118      | 813                    | 6.7                   | % AAA    |
| Non-U.S. govt. & agency         | 9,861                  | 10,557       | 696                    | 0.5                   | % A      |
| U.S. government                 | 32,082                 | 32,163       | 81                     | 1.6                   | % AA     |
| Municipal                       | 499,021                | 513,779      | 14,758                 | 24.9                  | % AA     |
| Total Fixed Income              | \$ 1,503,154           | \$ 1,546,191 | \$ 43,037              | 74.9                  | % AA     |
| Equity                          | \$ 214,239             | \$ 419,022   | \$ 204,783             | 20.3                  | %        |
| Other Invested Assets           | \$ 11,688              | \$ 11,688    | \$ —                   | 0.6                   | %        |
| Cash and short-term investments | \$ 87,100              | \$ 87,100    | \$ —                   | 4.2                   | %        |
| Total Portfolio                 | \$ 1,816,181           | \$ 2,064,001 | \$ 247,820             | 100.0                 | %        |

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

\*\*Asset-backed and commercial mortgage-backed securities

Our investment portfolio does not have any exposure to derivatives.

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As of September 30, 2014, our fixed income portfolio had the following rating distribution:

|       |       |   |
|-------|-------|---|
| AAA   | 17.3  | % |
| AA    | 44.1  | % |
| A     | 23.5  | % |
| BBB   | 9.9   | % |
| BB    | 3.1   | % |
| B     | 1.9   | % |
| CCC   | 0.1   | % |
| NR    | 0.1   | % |
| Total | 100.0 | % |

As of September 30, 2014, the duration of the fixed income portfolio was 4.6 years. Our fixed income portfolio remained well diversified, with 886 individual issues as of September 30, 2014.

Our investment portfolio has limited exposure to structured asset-backed securities (ABS). As of September 30, 2014, we had \$50.7 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.

As of September 30, 2014 we had \$87.5 million in commercial mortgage backed securities (CMBS) and \$260.9 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 6.7 percent of our investment portfolio at quarter end.

We had \$584.2 million in corporate fixed income securities as of September 30, 2014. During 2014, we initiated an investment allocation to high yield credit. This portfolio consists of floating rate bank loans and bonds that are below investment grade in credit quality and offer incremental yield over our core fixed income portfolio. As of September 30, 2014, we had \$51.2 million invested in the strategy.

We also maintain an allocation to municipal fixed income securities. As of September 30, 2014, we had \$513.8 million in municipal securities. As of September 30, 2014, approximately 90 percent of our municipal bond portfolio maintains an 'AA' or better rating, while 100 percent of the municipal bond portfolio is rated 'A' or better.

At September 30, 2014, our equity portfolio had a fair value of \$419.0 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, 2014, our equity portfolio had a dividend yield of 2.7 percent compared to 2.0 percent 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 14.2 percent on dividends, compared to 35.0 percent on taxable interest and 5.3 percent on municipal bond interest income. The equity portfolio is managed in a diversified and granular manner, with 82 individual names and no single stock exposure greater than 2 percent of the equity portfolio.

Other invested assets shown on the balance sheet as of September 30, 2014 include an investment in a low income housing tax credit partnership as well as membership in the Federal Home Loan Bank Chicago. During the third quarter of 2014, we recorded an interest in a low income housing tax credit partnership totaling \$10.0 million. The interest had a balance of \$9.9 million at September 30, 2014 and recognized a total tax benefit of \$0.1 million during the quarter. Our investment in FHLBC stock totaled \$1.8 million at the end of the third quarter.

Our capital structure is comprised of equity and debt outstanding. As of September 30, 2014, our capital structure consisted of \$149.6 million in 10-year maturity senior notes maturing in 2023 (debt) and \$933.5 million of shareholders' equity. Debt outstanding comprised 13.8 percent of total capital as of September 30, 2014. Interest and fees on debt obligations totaled \$5.6 million during the first nine months of 2014 compared to \$4.5 million for the same period in 2013. We have incurred interest expense on debt at an average interest rate of 4.91 percent for the first nine months of 2014 compared to 6.02 percent for the same period in the prior year.



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We paid a quarterly cash dividend of \$0.18 per share on September 19, 2014, the same amount as the prior quarter. We have paid dividends for 153 consecutive quarters and increased dividends in each of the last 39 years.

Our insurance subsidiaries are organized in a vertical structure with RLI Ins. as the first-level, or principal, insurance subsidiary of RLI Corp. At the holding company (RLI Corp.) level, we rely largely on dividends from our insurance company subsidiaries to meet our obligations for paying principal and interest on outstanding debt, corporate expenses and dividends to RLI Corp. shareholders. As discussed further below, dividend payments to RLI Corp. from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the insurance regulatory authorities of Illinois. As a result, we may not be able to receive dividends from such subsidiary at times and in amounts necessary to pay desired dividends to RLI Corp. shareholders. On a GAAP basis, as of September 30, 2014, our holding company had \$933.5 million in equity. This includes amounts related to the equity of our insurance subsidiaries, which is subject to regulatory restrictions under state insurance laws. The unrestricted portion of holding company net assets is comprised primarily of investments and cash, including \$66.3 million in liquid assets. Unrestricted funds at the holding company are available to fund debt interest, general corporate obligations and dividend payments to our shareholders. If necessary, the holding company also has other potential sources of liquidity that could provide for additional funding to meet corporate obligations or pay shareholder dividends, which include a revolving line of credit, as well as issuances of common stock and debt.

Ordinary dividends, which may be paid by our principal insurance subsidiary without prior regulatory approval, are subject to certain limitations based upon statutory income, surplus and earned surplus. The maximum ordinary dividend distribution from our principal insurance subsidiary in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Ins. policyholder 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. Ordinary dividends are further restricted by the requirement that they be paid from earned surplus. Any dividend distribution in excess of the ordinary dividend limits is deemed extraordinary and requires prior approval from the Illinois Department of Insurance. In the first nine months of 2014, RLI Ins. paid a total of \$50.0 million in ordinary dividends to RLI Corp. In 2013, our principal insurance subsidiary paid ordinary dividends totaling \$40.0 million to RLI Corp. No extraordinary dividends were paid during 2013. As of September 30, 2014, \$155.9 million of the net assets of our principal insurance subsidiary are not restricted and could be distributed to RLI Corp. as ordinary dividends. Because the limitations are based upon a rolling 12-month period, the presence, amount and impact of these restrictions vary over time.

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 85 percent rated "A" or better by at least two nationally recognized rating organizations.

On an overall basis, our exposure to market risk has not significantly changed from that reported in our December 31, 2013 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

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Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective, as of the end of the period covered by this report.

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

No changes were made to our internal control over financial reporting during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings –

In July 2014, the Belmont Massachusetts Contributory Retirement System filed a putative class action and shareholder derivative lawsuit against RLI Corp. and its Board of Directors in Illinois state court. The lawsuit alleges breach of contract and breach of fiduciary duty by its directors relating to adjustments made to the exercise price of outstanding stock options under our equity-based incentive plans, as a result of extraordinary cash dividends paid by us in 2011, 2012 and 2013. The lawsuit seeks, among other things, to subject these adjustments to a vote of our shareholders and does not seek monetary damages or compensation for shareholders, but does seek payment for plaintiff's attorney fees. We believe that such allegations are without merit, that we have valid defenses and will vigorously contest this action. Because of the uncertainty and costs incident to litigating this matter, RLI may seek to settle or otherwise resolve this matter on terms we deem to be in the best interests of the company and its shareholders. While it is not possible to predict the ultimate disposition of this matter and whether it will be resolved consistent with our positions, RLI's management expects that the outcome will not have a material adverse effect on our financial condition, results of operations or cash flows.

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 2014, 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.

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Item 6. Exhibits

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

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

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

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

Exhibit 101 XBRL-Related Documents

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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 27, 2014