

RLI CORP  
Form 10-Q  
April 28, 2014

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2014**

**or**

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

**For the transition period from                      to**

**Commission File Number: 001-09463**

**RLI Corp.**

(Exact name of registrant as specified in its charter)

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**ILLINOIS**

(State or other jurisdiction of  
incorporation or organization)

**37-0889946**

(I.R.S. Employer  
Identification Number)

**9025 North Lindbergh Drive, Peoria, IL**

(Address of principal executive offices)

**61615**

(Zip Code)

**(309) 692-1000**

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☐

(Do not check if a smaller reporting company)

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of April 11, 2014, the number of shares outstanding of the registrant's Common Stock was 42,989,841.

**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 March 31, |            |
|--|--|------------|
|  | 2014   | 2013       |
| Net premiums earned                                  | \$ 161,132                                     | \$ 144,151 |
| Net investment income                                | 13,582   | 12,886     |
| Net realized investment gains                        | 6,501  | 3,684      |
| Consolidated revenue                                 | \$ 181,215                                     | \$ 160,721 |
| Losses and settlement expenses                       | \$ 71,016                                      | \$ 61,448  |
| Policy acquisition costs                             | 55,051   | 50,336     |
| Insurance operating expenses                         | 12,533   | 12,569     |
| Interest expense on debt                             | 1,851  | 1,512      |
| General corporate expenses                           | 2,198  | 2,386      |
| Total expenses                                       | \$ 142,649                                     | \$ 128,251 |
| Equity in earnings of unconsolidated investees       | 3,425  | 3,499      |
| Earnings before income taxes                         | \$ 41,991                                      | \$ 35,969  |
| Income tax expense                                   | 13,022   | 11,122     |
| Net earnings   | \$ 28,969                                      | \$ 24,847  |
| Other comprehensive earnings, net of tax             | 17,737   | 17,553     |
| Comprehensive earnings                               | \$ 46,706                                      | \$ 42,400  |
| Earnings per share:                                  |  |            |
| Basic:   |  |            |
| Basic net earnings per share                         | \$ 0.67  | \$ 0.58    |
| Basic comprehensive earnings per share               | \$ 1.09  | \$ 1.00    |
| Diluted:   |  |            |
| Diluted net earnings per share                       | \$ 0.66  | \$ 0.57    |
| Diluted comprehensive earnings per share             | \$ 1.07  | \$ 0.98    |
| Weighted average number of common shares outstanding |  |            |
| Basic  | 42,985   | 42,544     |
| Diluted  | 43,674   | 43,245     |
| Cash dividends paid per common share                 | \$ 0.17  | \$ 0.16    |

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)                                     | March 31<br>2014    | December 31,<br>2013 |
|---|---------------------|----------------------|
| <b>ASSETS</b>   |                     |                      |
| Investments   |                     |                      |
| Fixed income  |                     |                      |
| Available-for-sale, at fair value                                     | \$ 1,467,282        | \$ 1,440,052         |
| Held-to-maturity, at amortized cost                                   | 651                 | 651                  |
| Equity securities, at fair value                                      | 426,680             | 418,654              |
| Short-term investments, at cost                                       | 37,030              | 23,232               |
| Cash  | 20,618              | 39,469               |
| Total investments and cash  | \$ 1,952,261        | \$ 1,922,058         |
| Accrued investment income   | 13,256              | 15,710               |
| Premiums and reinsurance balances receivable                          | 166,165             | 152,509              |
| Ceded unearned premium  | 58,835              | 60,407               |
| Reinsurance balances recoverable on unpaid losses                     | 353,674             | 354,924              |
| Deferred policy acquisition costs                                     | 62,586              | 61,508               |
| Property and equipment  | 42,107              | 40,261               |
| Investment in unconsolidated investees                                | 58,568              | 49,793               |
| Goodwill and intangibles  | 74,641              | 74,876               |
| Other assets  | 9,254               | 8,264                |
| <b>TOTAL ASSETS</b>   | <b>\$ 2,791,347</b> | <b>\$ 2,740,310</b>  |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                           |                     |                      |
| Liabilities:  |                     |                      |
| Unpaid losses and settlement expenses                                 | \$ 1,141,735        | \$ 1,129,433         |
| Unearned premiums   | 390,968             | 392,081              |
| Reinsurance balances payable  | 44,784              | 47,334               |
| Funds held  | 58,850              | 61,656               |
| Income taxes-deferred   | 68,995              | 57,801               |
| Bonds payable, long-term debt   | 149,593             | 149,582              |
| Accrued expenses  | 34,069              | 59,596               |
| Other liabilities   | 32,777              | 13,861               |
| <b>TOTAL LIABILITIES</b>  | <b>\$ 1,921,771</b> | <b>\$ 1,911,344</b>  |
| Shareholders' Equity  |                     |                      |
| Common stock (\$1 par value, 100,000,000 shares authorized)           |                     |                      |
| (65,919,435 shares issued, 42,989,221 shares outstanding at 3/31/14)  |                     |                      |
| (65,912,638 shares issued, 42,982,424 shares outstanding at 12/31/13) | \$ 65,919           | \$ 65,913            |
| Paid-in capital   | 209,908             | 208,705              |
| Accumulated other comprehensive earnings                              | 153,764             | 136,027              |
| Retained earnings   | 832,984             | 811,320              |
| Deferred compensation   | 11,565              | 11,562               |
| Less: Treasury shares at cost   |                     |                      |
| (22,930,214 shares at 3/31/14 and 12/31/13)                           | (404,564)           | (404,561)            |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>                                     | <b>\$ 869,576</b>   | <b>\$ 828,966</b>    |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                     | <b>\$ 2,791,347</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 Three-Month Periods<br>Ended March 31, |              |
|---|--|--------------|
|   | 2014   | 2013         |
| Net cash used in operating activities             | \$ (2,007)                                     | \$ (6,328)   |
| Cash Flows from Investing Activities              |  |              |
| Investments purchased                             | \$ (129,559)                                   | \$ (123,747) |
| Investments sold                                  | 92,989   | 54,647       |
| Investments called or matured                     | 31,770   | 36,680       |
| Net change in short-term investments              | 2,286  | 26,329       |
| Net property and equipment purchased              | (2,933)  | (4,276)      |
| Investment in equity method investee              | (5,301)  |              |
| Net cash used in investing activities             | \$ (10,748)                                    | \$ (10,367)  |
| Cash Flows from Financing Activities              |  |              |
| Cash dividends paid                               | \$ (7,305)                                     | \$ (6,807)   |
| Stock plan share issuance                         | 1,123  | 819          |
| Excess tax benefit from exercise of stock options | 86   | 740          |
| Net cash used in financing activities             | \$ (6,096)                                     | \$ (5,248)   |
| Net decrease in cash                              | \$ (18,851)                                    | \$ (21,943)  |
| Cash at the beginning of the period               | \$ 39,469                                      | \$ 44,314    |
| Cash at March 31                                  | \$ 20,618                                      | \$ 22,371    |

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

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

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**A. BASIS OF PRESENTATION**

The unaudited condensed consolidated interim financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 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 March 31, 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**

We have not adopted any new accounting standards as there have been no accounting standard updates which would impact our financial statements.

**C. PROSPECTIVE ACCOUNTING STANDARDS**

There are no prospective accounting standards which would impact our financial statements as of March 31, 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 \$74.6 million at March 31, 2014. These assets



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relate to acquisition activity including our acquisitions of Contractors Bonding and Insurance Company (CBIC) and Rockbridge Underwriting Agency (Rockbridge).

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 CBIC acquisition in April 2011 totaled \$32.3 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. Definite-lived intangible assets related to the CBIC acquisition totaled \$3.1 million, net of amortization, as of March 31, 2014. The remaining \$16.1 million of goodwill and intangibles relates to our purchase of Rockbridge in November 2012. Of this amount, \$12.4 million is recorded as goodwill attributable to our casualty segment. The remaining \$3.7 million relates to definite-lived intangible assets, net of amortization, as of March 31, 2014. Annual impairment testing was performed on each of these goodwill and indefinite-lived intangible assets during 2013. Based upon these reviews, the assets were not impaired. In addition, as of March 31, 2014, there were no triggering events that occurred that would suggest an updated review was necessary.

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 first quarter of 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 March 31, 2014 |                         |                     | For the Three-Month Period<br>Ended March 31, 2013 |                         |                     |
|--|--|-------------------------|---------------------|--|-------------------------|---------------------|
|  | Income<br>(Numerator)                              | Shares<br>(Denominator) | Per Share<br>Amount | Income<br>(Numerator)                              | Shares<br>(Denominator) | Per Share<br>Amount |
| <b>Basic EPS</b>                           |  |                         |                     |  |                         |                     |
| Income available to common<br>shareholders | \$ 28,969  | 42,985                  | \$ 0.67             | \$ 24,847  | 42,544                  | \$ 0.58             |
| <b>Effect of Dilutive Securities</b>       |  |                         |                     |  |                         |                     |
| Stock options                              |  | 689                     |                     |  | 701                     |                     |
| <b>Diluted EPS</b>                         |  |                         |                     |  |                         |                     |
| Income available to common<br>shareholders | \$ 28,969  | 43,674                  | \$ 0.66             | \$ 24,847  | 43,245                  | \$ 0.57             |

## 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 a 35 percent tax rate. The following table illustrates the changes in the balance of each component of accumulated other comprehensive earnings for each period presented in the unaudited condensed consolidated interim financial statements.

| (in thousands)   | For the Three-Month Periods Ended |         |      |         |
|--|-----------------------------------|---------|------|---------|
|  | March 31,                         |         |      |         |
|  | 2014                              |         | 2013 |         |
| <b>Unrealized Gains/Losses on Available-for-Sale Securities</b>    |                                   |         |      |         |
| Beginning balance  | \$                                | 136,027 | \$   | 143,170 |
| Other comprehensive earnings before reclassifications              |                                   | 21,960  |      | 20,267  |
| Amounts reclassified from accumulated other comprehensive earnings |                                   | (4,223) |      | (2,714) |
| Net current-period other comprehensive earnings                    | \$                                | 17,737  | \$   | 17,553  |
| Ending balance   | \$                                | 153,764 | \$   | 160,723 |

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.

|                |  | Amount Reclassified from Accumulated<br>Other Comprehensive Earnings<br>For the Three-Month Periods Ended<br>March 31, |      | Affected line item in the<br>Statement of Earnings |
|----------------|--|--|------|--|
| (in thousands) | Component of Accumulated<br>Other Comprehensive Earnings | 2014   | 2013 |  |

|   |    |         |    |         |  |
|---|----|---------|----|---------|--|
| Unrealized gains and losses on<br>available-for-sale securities | \$ | 6,497   | \$ | 4,176   | Net realized investment gains                                      |
|   |    |         |    |         | Other-than-temporary<br>impairment (OTTI) losses on<br>investments |
|   | \$ | 6,497   | \$ | 4,176   | Earnings before income taxes                                       |
|   |    | (2,274) |    | (1,462) | Income tax expense   |
|   | \$ | 4,223   | \$ | 2,714   | 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



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determined using Level 3 inputs as defined in note 3 to the unaudited condensed consolidated interim financial statements, Fair Value Measurements.

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

## Available-for-Sale Securities

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

### Available-for-sale

(in thousands)

| Asset Class               | 3/31/2014              |                        |                         |                     |
|---------------------------|------------------------|------------------------|-------------------------|---------------------|
|                           | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value          |
| U.S. agency               | \$ 2,000               | \$                     | \$ (3)                  | \$ 1,997            |
| Corporate                 | 543,143                | 25,241                 | (2,803)                 | 565,581             |
| Mtge/ABS/CMBS*            | 341,781                | 8,581                  | (5,408)                 | 344,954             |
| Non-U.S. govt. & agency   | 13,852                 | 736                    |                         | 14,588              |
| U.S. government           | 18,205                 | 190                    |                         | 18,395              |
| Municipal                 | 518,642                | 9,171                  | (6,046)                 | 521,767             |
| <b>Total Fixed Income</b> | <b>\$ 1,437,623</b>    | <b>\$ 43,919</b>       | <b>\$ (14,260)</b>      | <b>\$ 1,467,282</b> |
| <b>Equity</b>             | <b>\$ 220,292</b>      | <b>\$ 206,744</b>      | <b>\$ (356)</b>         | <b>\$ 426,680</b>   |

### Available-for-sale

(in thousands)

| Asset Class               | 12/31/2013             |                        |                         |                     |
|---------------------------|------------------------|------------------------|-------------------------|---------------------|
|                           | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair 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             |
| <b>Total Fixed Income</b> | <b>\$ 1,431,049</b>    | <b>\$ 37,661</b>       | <b>\$ (28,658)</b>      | <b>\$ 1,440,052</b> |

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|               |           |                |           |                |           |              |           |                |
|---------------|-----------|----------------|-----------|----------------|-----------|--------------|-----------|----------------|
| <b>Equity</b> | <b>\$</b> | <b>218,848</b> | <b>\$</b> | <b>200,081</b> | <b>\$</b> | <b>(275)</b> | <b>\$</b> | <b>418,654</b> |
|---------------|-----------|----------------|-----------|----------------|-----------|--------------|-----------|----------------|

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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 March 31, 2014:

| AFS<br>(in thousands)                 | 3/31/2014         |               |
|---------------------------------------|-------------------|---------------|
|                                       | Amortized<br>Cost | Fair<br>Value |
| Due in one year or less               | \$ 11,988         | \$ 12,080     |
| Due after one year through five years | 176,091           | 184,885       |
| Due after five years through 10 years | 652,781           | 669,893       |
| Due after 10 years                    | 254,982           | 255,470       |
| Mtge/ABS/CMBS*                        | 341,781           | 344,954       |
| Total available-for-sale              | \$ 1,437,623      | \$ 1,467,282  |

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

#### *Held-to-Maturity Debt Securities*

The carrying value and fair value of held-to-maturity securities was \$0.7 million at March 31, 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 March 31, 2014 and December 31, 2013. As of March 31, 2014, the carrying value and fair value of all debt securities held-to-maturity have a contractual maturity date of one year or less.

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 March 31, 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 March 31, 2014 unrealized losses, as shown in the following tables, were 0.8 percent of total invested assets. Unrealized losses decreased in 2014, as interest rates declined during the first quarter of the year.

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| (in thousands)                | March 31, 2014 |                   |             | December 31, 2013 |                   |             |
|-------------------------------|----------------|-------------------|-------------|-------------------|-------------------|-------------|
|                               | < 12 Mos.      | 12 Mos. & Greater | Total       | < 12 Mos.         | 12 Mos. & Greater | Total       |
| <b>U.S. Agency</b>            |                |                   |             |                   |                   |             |
| Fair value                    | \$ 1,997       | \$                | \$ 1,997    | \$ 5,760          | \$                | \$ 5,760    |
| Cost or amortized cost        | 2,000          |                   | 2,000       | 5,997             |                   | 5,997       |
| Unrealized Loss               | \$ (3)         | \$                | \$ (3)      | \$ (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                    | \$ 98,902      | \$ 7,737          | \$ 106,639  | \$ 118,283        | \$                | \$ 118,283  |
| Cost or amortized cost        | 102,619        | 8,199             | 110,818     | 124,034           |                   | 124,034     |
| Unrealized Loss               | \$ (3,717)     | \$ (462)          | \$ (4,179)  | \$ (5,751)        | \$                | \$ (5,751)  |
| <b>ABS/CMBS*</b>              |                |                   |             |                   |                   |             |
| Fair value                    | \$ 33,089      | \$ 7,668          | \$ 40,757   | \$ 54,115         | \$                | \$ 54,115   |
| Cost or amortized cost        | 33,777         | 8,209             | 41,986      | 56,014            |                   | 56,014      |
| Unrealized Loss               | \$ (688)       | \$ (541)          | \$ (1,229)  | \$ (1,899)        | \$                | \$ (1,899)  |
| <b>Corporate</b>              |                |                   |             |                   |                   |             |
| Fair value                    | \$ 159,687     | \$                | \$ 159,687  | \$ 190,470        | \$ 2,245          | \$ 192,715  |
| Cost or amortized cost        | 162,490        |                   | 162,490     | 198,250           | 2,477             | 200,727     |
| Unrealized Loss               | \$ (2,803)     | \$                | \$ (2,803)  | \$ (7,780)        | \$ (232)          | \$ (8,012)  |
| <b>Municipal</b>              |                |                   |             |                   |                   |             |
| Fair value                    | \$ 249,856     | \$                | \$ 249,856  | \$ 309,407        | \$ 943            | \$ 310,350  |
| Cost or amortized cost        | 255,902        |                   | 255,902     | 322,095           | 949               | 323,044     |
| Unrealized Loss               | \$ (6,046)     | \$                | \$ (6,046)  | \$ (12,688)       | \$ (6)            | \$ (12,694) |
| <b>Subtotal, fixed income</b> |                |                   |             |                   |                   |             |
| Fair value                    | \$ 543,531     | \$ 15,405         | \$ 558,936  | \$ 679,860        | \$ 3,188          | \$ 683,048  |
| Cost or amortized cost        | 556,788        | 16,408            | 573,196     | 708,280           | 3,426             | 711,706     |
| Unrealized Loss               | \$ (13,257)    | \$ (1,003)        | \$ (14,260) | \$ (28,420)       | \$ (238)          | \$ (28,658) |
| <b>Equity securities</b>      |                |                   |             |                   |                   |             |
| Fair value                    | \$ 3,275       | \$ 2,472          | \$ 5,747    | \$ 2,394          | \$                | \$ 2,394    |
| Cost or amortized cost        | 3,434          | 2,669             | 6,103       | 2,669             |                   | 2,669       |
| Unrealized Loss               | \$ (159)       | \$ (197)          | \$ (356)    | \$ (275)          | \$                | \$ (275)    |
| <b>Total</b>                  |                |                   |             |                   |                   |             |
| Fair value                    | \$ 546,806     | \$ 17,877         | \$ 564,683  | \$ 682,254        | \$ 3,188          | \$ 685,442  |
| Cost or amortized cost        | 560,222        | 19,077            | 579,299     | 710,949           | 3,426             | 714,375     |
| Unrealized Loss               | \$ (13,416)    | \$ (1,200)        | \$ (14,616) | \$ (28,695)       | \$ (238)          | \$ (28,933) |

\*Asset-backed & commercial mortgage-backed



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The following table shows the composition of the fixed income securities in unrealized loss positions at March 31, 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) |            |                    |                     |
|----------------|-----------------------------|---------------------------------|------------------------|------------|--------------------|---------------------|
|                |                             |                                 | Amortized<br>Cost      | Fair Value | Unrealized<br>Loss | Percent<br>to Total |
| 1              | AAA/AA/A                    | Aaa/Aa/A                        | \$ 521,155             | \$ 507,536 | \$ (13,619)        | 95.6%               |
| 2              | BBB                         | Baa                             | 24,881                 | 24,418     | (463)              | 3.2%                |
| 3              | BB                          | Ba                              | 20,571                 | 20,427     | (144)              | 1.0%                |
| 4              | B                           | B                               | 6,589                  | 6,555      | (34)               | 0.2%                |
| 5              | CCC or lower                | Caa or lower                    |                        |            |                    |                     |
| 6              |                             |                                 |                        |            |                    |                     |
|                |                             | Total                           | \$ 573,196             | \$ 558,936 | \$ (14,260)        | 100.0%              |

### *Cash and Short-term Investments*

Cash consists of uninvested balances in bank accounts. We had a cash balance of \$20.6 million at the end of the first 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 March 31, 2014 was \$37.0 million compared to \$23.2 million at December 31, 2013.

### *Evaluating Investments for OTTI*

The fixed income portfolio contained 306 securities in an unrealized loss position as of March 31, 2014. The \$14.3 million in associated unrealized losses for these 306 securities represents 1.0 percent of the fixed income portfolio's cost basis. Of these 306 securities, six 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 March 31, 2014, we held two common stock securities that were in an unrealized loss position. The unrealized loss on these securities was \$0.4 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.

### 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. These valuations are based on quoted prices that are readily and regularly available in an active market.

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

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

As a part of management's process to determine fair value, we utilize 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 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 March 31, 2014  |   |   |    | Total     |
|-------------------------------------|---|---|---|----|-----------|
|                                     | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Fair Value Measurements Using<br>Significant Other<br>Observable<br>Inputs<br>(Level 2) | Fair Value Measurements Using<br>Significant<br>Unobservable<br>Inputs<br>(Level 3) |    |           |
| Total trading securities            | \$  | \$  | \$  | \$ |           |
| Available-for-sale securities       |   |   |   |    |           |
| U.S. agency                         | \$  | \$ 1,997  | \$  | \$ | 1,997     |
| Corporate                           |   | 565,581   |   |    | 565,581   |
| Mortgage-backed                     |   | 239,148   |   |    | 239,148   |
| ABS/CMBS*                           |   | 105,806   |   |    | 105,806   |
| Non-U.S. govt. & agency             |   | 14,588  |   |    | 14,588    |
| U.S. government                     |   | 18,395  |   |    | 18,395    |
| Municipal                           |   | 521,767   |   |    | 521,767   |
| Equity                              |   | 426,680   |   |    | 426,680   |
| Total available-for-sale securities | \$  | 426,680   | \$  | \$ | 1,893,962 |
| Total                               | \$  | 426,680   | \$  | \$ | 1,893,962 |

\*Asset-backed & commercial mortgage-backed

| (in thousands)                      | As of December 31, 2013   |   |   |    | Total     |
|-------------------------------------|---|---|---|----|-----------|
|                                     | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Fair Value Measurements Using<br>Significant Other<br>Observable<br>Inputs<br>(Level 2) | Fair Value Measurements Using<br>Significant<br>Unobservable<br>Inputs<br>(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   | \$  | \$ | 1,858,706 |
| Total                               | \$  | 418,654   | \$  | \$ | 1,858,706 |

\*Asset-backed & 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 three-month period ended March 31, 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 grants of up to 3,000,000 shares (subject to adjustment for changes in our capitalization). Since 2005, 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 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 total number of shares of common stock available for distribution under the LTIP may not exceed 4,000,000 shares (subject to adjustment for changes in our capitalization). Since 2010, we have granted 2,363,000 stock options under the LTIP, including 50,500 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.

The following tables summarize option activity for the periods ended March 31, 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                        | 50,500                              | \$ 40.43                                 |   |   |
| Options exercised                      | (4,700)                             | \$ 18.53                                 |   | \$ 115  |
| Options canceled/forfeited             | (740)                               | \$ 16.51                                 |   |   |
| Outstanding options at March 31, 2014  | 2,640,144                           | \$ 26.33                                 | 5.36  | \$ 47,359                                     |
| Exercisable options at March 31, 2014  | 972,284                             | \$ 20.66                                 | 4.07  | \$ 22,927                                     |

|  | 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                        | 59,000                              | \$ 34.74                                 |   |   |
| Options exercised                      | (85,146)                            | \$ 18.05                                 |   | \$ 1,408                                      |
| Options canceled/forfeited             | (38,820)                            | \$ 25.45                                 |   |   |
| Outstanding options at March 31, 2013  | 2,880,238                           | \$ 22.56                                 | 5.28  | \$ 38,492                                     |
| Exercisable options at March 31, 2013  | 1,310,778                           | \$ 18.49                                 | 4.10  | \$ 22,857                                     |

The majority of our 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 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, 50,500 options were granted with an average exercise price of \$40.43 and a weighted average fair value of \$8.14. We recognized \$0.9 million of expense in the first three months of 2014 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.3 million in the first three months of 2014 related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.1 million, which will be recognized over the remainder of the vesting period. Comparatively, we recognized \$0.8 million of expense in the first three months of 2013 and a tax benefit of \$0.3 million 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 March 31:

|                                       | 2014       | 2013       |
|---------------------------------------|------------|------------|
| Weighted-average fair value of grants | \$ 8.14    | \$ 6.69    |
| Risk-free interest rates              | 1.76%      | 1.14%      |
| Dividend yield                        | 1.92%      | 1.98%      |
| Expected volatility                   | 25.20%     | 25.52%     |
| Expected option life                  | 5.66 years | 5.65 years |

The risk-free rate is determined based on U.S. treasury yields that most closely approximate the option's expected life. The dividend yield is calculated based on the average annualized dividends paid during the most recent five-year period. It excludes the special dividends paid in the fourth quarters of 2013 and prior years. The expected volatility is calculated based on the mean reversion of RLI's stock. The expected option life is determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant.

In 2013, we began providing restricted common stock to outside directors. Shares are issued to outside directors from the LTIP as part of annual director compensation and are directly owned by each director on the date of issuance. Currently, each director receives restricted shares worth \$10,000 at the time of issuance. The shares are issued annually in the first quarter and include 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.

**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 March 31,<br>REVENUES |         |      |         |
|------------------------------------|--|---------|------|---------|
|                                    | 2014   |         | 2013 |         |
| Net premiums earned:               |  |         |      |         |
| Casualty                           | \$   | 90,977  | \$   | 72,969  |
| Property                           |  | 43,318  |      | 44,981  |
| Surety                             |  | 26,837  |      | 26,201  |
| Segment totals before income taxes | \$   | 161,132 | \$   | 144,151 |
| Net investment income              |  | 13,582  |      | 12,886  |
| Net realized gains                 |  | 6,501   |      | 3,684   |
| Total consolidated revenue         | \$   | 181,215 | \$   | 160,721 |

|  | NET EARNINGS |         |      |         |
|--|--------------|---------|------|---------|
|  | 2014         |         | 2013 |         |
| Casualty                                       | \$           | 6,078   | \$   | 4,104   |
| Property                                       |              | 9,678   |      | 10,924  |
| Surety   |              | 6,776   |      | 4,770   |
| Net underwriting income                        | \$           | 22,532  | \$   | 19,798  |
| Net investment income                          |              | 13,582  |      | 12,886  |
| Net realized gains                             |              | 6,501   |      | 3,684   |
| General corporate expense and interest on debt |              | (4,049) |      | (3,898) |
| Equity in earnings of unconsolidated investees |              | 3,425   |      | 3,499   |
| Total earnings before income taxes             | \$           | 41,991  | \$   | 35,969  |
| Income tax expense                             |              | 13,022  |      | 11,122  |
| Total net earnings                             | \$           | 28,969  | \$   | 24,847  |



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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 March 31, |         |      |         |
|----------------------------------|--|---------|------|---------|
|                                  | 2014   |         | 2013 |         |
| <b>Casualty</b>                  |  |         |      |         |
| Commercial and personal umbrella | \$   | 24,756  | \$   | 18,950  |
| General liability                |  | 19,932  |      | 20,777  |
| Commercial transportation        |  | 14,511  |      | 9,934   |
| Professional services            |  | 12,861  |      | 9,009   |
| P&C package business             |  | 8,283   |      | 7,421   |
| Executive products               |  | 4,684   |      | 4,716   |
| Medical professional liability   |  | 3,700   |      | 750     |
| Other casualty                   |  | 2,250   |      | 1,412   |
| Total                            | \$   | 90,977  | \$   | 72,969  |
| <b>Property</b>                  |  |         |      |         |
| Commercial property              | \$   | 20,433  | \$   | 19,616  |
| Marine                           |  | 12,201  |      | 14,614  |
| Property reinsurance             |  | 3,361   |      | 5,272   |
| Crop reinsurance                 |  | 1,186   |      | 1,267   |
| Other property                   |  | 6,137   |      | 4,212   |
| Total                            | \$   | 43,318  | \$   | 44,981  |
| <b>Surety</b>                    |  |         |      |         |
| Miscellaneous                    | \$   | 9,482   | \$   | 9,481   |
| Contract                         |  | 6,761   |      | 6,459   |
| Commercial                       |  | 6,134   |      | 5,711   |
| Oil and Gas                      |  | 4,460   |      | 4,550   |
| Total                            | \$   | 26,837  | \$   | 26,201  |
| <b>Grand Total</b>               | \$   | 161,132 | \$   | 144,151 |

## 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. For the first quarter of 2014, our share of Prime's earnings amounted to \$0.1 million.

Additionally, we entered into a 25 percent quota share treaty with Prime, effective January 1, 2014. During the first quarter of 2014, we assumed gross premiums of \$2.5 million related to this quota share agreement.

**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.

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 also 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. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty segment is also subject to inflation risk and may be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

Our property segment is comprised primarily of commercial fire, earthquake, difference in conditions, marine, facultative and treaty reinsurance including crop and 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 has led to softer reinsurance pricing in the first quarter of 2014, which will likely impact primary rates as well. 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.

***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 on 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 unconsolidated investee earnings.

***Combined Ratio***

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

***Net Unpaid Loss and Settlement Expenses***

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



### **Critical Accounting Policies**

In preparing the unaudited condensed consolidated 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.

#### *LOSSES AND SETTLEMENT EXPENSES*

### **OVERVIEW**

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

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

Due to inherent uncertainty underlying loss reserve estimates, including, but not limited to, the future settlement environment, final resolution of the estimated liability may be different from that anticipated at the reporting date. Therefore, actual paid losses in the future may yield a significantly

different amount than currently reserved    favorable or unfavorable.

The amount by which estimated losses differ from those originally reported for a period is known as    development.    Development is unfavorable when the losses ultimately settle for more than the levels at which they were reserved or subsequent estimates indicate a basis for reserve increases on unresolved claims. Development is favorable when losses ultimately settle for less than the amount reserved or subsequent estimates indicate a basis for reducing loss reserves on unresolved claims. We reflect favorable or unfavorable developments of loss reserves in the results of operations in the period the estimates are changed.

We record two categories of loss and LAE reserves    case-specific reserves and IBNR reserves.

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

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

Our IBNR reserving process involves three steps: (1) an initial IBNR generation process that is prospective in nature, (2) a loss and LAE reserve estimation process that occurs retrospectively and (3) a subsequent discussion and reconciliation between our prospective and retrospective IBNR estimates, which includes changes in our provisions for IBNR where deemed appropriate. These three processes are discussed in more detail in the following sections.

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



Decisions regarding our best estimate of ultimate loss and LAE reserves are approved by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at March 31, 2014, make a reasonable provision to meet our future obligations.

## **INITIAL IBNR GENERATION PROCESS**

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

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

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

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

The initial loss and ALAE ratios that are applied to earned premium are reviewed at least semi-annually. Prospective estimates are made based on historical loss experience adjusted for exposure mix, price change and loss cost trends. The initial loss and ALAE ratios also reflect our judgment as to estimation risk. We consider estimation risk by product and coverage within product, if applicable. A product with greater overall volatility and

uncertainty has greater estimation risk. Products or coverages with higher estimation risk include, but are not limited to, the following characteristics:

- Significant changes in underlying policy terms and conditions,
- A new business or one experiencing significant growth and/or high turnover,
- Small volume or lacking internal data requiring significant utilization of external data,
- Unique reinsurance features including those with aggregate stop-loss, reinstatement clauses, commutation provisions or clash protection,
- Longer emergence patterns with exposures to latent unforeseen mass tort,
- Assumed reinsurance businesses where there is an extended reporting lag and/or a heavier utilization of ceding company data and claims and product expertise,
- High severity and/or low frequency,
- Operational processes undergoing significant change and/or
- High sensitivity to significant swings in loss trends, economic change or judicial change.

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

#### **LOSS AND LAE RESERVE ESTIMATION PROCESS**

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

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



In addition to the review of historical claim reporting and payment patterns, we also incorporate estimated losses relative to premium (loss ratios) by year into the analysis. The expected loss ratios are based on a review of historical loss performance, trends in frequency and severity and price level changes. The estimates are subject to judgment including consideration given to available internal and industry data, growth and policy turnover, changes in policy limits, changes in underlying policy provisions, changes in legal and regulatory interpretations of policy provisions and changes in reinsurance structure. For the most current year, these are equivalent with the ratios used in the initial IBNR generation process. Increased recognition is given to actual emergence as the years age.

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

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

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

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

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

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

A considerable degree of judgment in the evaluation of all these factors is involved in the analysis of reserves. The human element in the application of

judgment is unavoidable when faced with uncertainty. Different experts will choose different assumptions based on their individual backgrounds, professional experiences and areas of focus. Hence, the estimates selected by various qualified experts may differ significantly from each other. We consider this uncertainty by examining our historic reserve accuracy and through an internal peer review process.

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

#### **DETERMINATION OF OUR BEST ESTIMATE**

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

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

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

Actuarial methods attempt to quantify future outcomes. However, insurance companies are subject to unique exposures that are difficult to foresee at the point coverage is initiated and, often, many years subsequent. Judicial and regulatory bodies involved in interpretation of insurance contracts have increasingly found opportunities to expand coverage beyond that which was intended or contemplated at the time the policy was issued. Many of these policies are issued on an all risk and occurrence basis. Aggressive plaintiff attorneys have often sought coverage beyond the insurer's original

intent. Some examples would be the industry's ongoing asbestos and environmental litigation, court interpretations of exclusionary language for mold and construction defect and debates over wind versus flood as the cause of loss from major hurricane events.

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

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

Loss reserve estimates are subject to a high degree of variability due to the inherent uncertainty of ultimate settlement values. Periodic adjustments to these estimates will likely occur as the actual loss emergence reveals itself over time. Our loss reserving processes reflect accepted actuarial practices and our methodologies result in a reasonable provision for reserves as of March 31, 2014.

#### *INVESTMENT VALUATION AND OTTI*

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

We classify our investments in debt and equity securities into one of three categories. Held-to-maturity securities are carried at amortized cost. Available-for-sale securities are carried at fair value with unrealized gains/losses recorded as a component of comprehensive earnings and shareholders' equity, net of deferred income taxes. Trading securities are reported at fair value with unrealized gains and losses included in earnings. During 2013, we sold our remaining debt securities classified as trading.

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 pricing categories that are used to classify fair value.

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

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

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

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

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



For mortgage-backed securities and asset-backed securities that have significant unrealized loss positions and major rating agency downgrades, credit impairment is assessed using a cash flow model that estimates likely payments using security-specific collateral and transaction structure. All of our mortgage-backed and asset-backed securities remain AAA-rated by the major rating agencies and the fair value is not significantly less than amortized cost.

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

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

#### *RECOVERABILITY OF REINSURANCE BALANCES*

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

#### *DEFERRED POLICY ACQUISITION COSTS*

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

#### *DEFERRED TAXES*

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

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

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

**THREE MONTHS ENDED MARCH 31, 2014 COMPARED TO THREE MONTHS ENDED MARCH 31, 2013**

Consolidated revenues, as displayed in the table that follows, totaled \$181.2 million for the first three months of 2014 compared to \$160.7 million for the same period in 2013.

|   | For the Three-Month Periods<br>Ended March 31, |         |      |         |
|---|--|---------|------|---------|
|   | 2014   |         | 2013 |         |
| <b>Consolidated revenues</b> (in thousands) |  |         |      |         |
| Net premiums earned                         | \$   | 161,132 | \$   | 144,151 |
| Net investment income                       |  | 13,582  |      | 12,886  |
| Net realized investment gains               |  | 6,501   |      | 3,684   |
| Total consolidated revenue                  | \$   | 181,215 | \$   | 160,721 |

Consolidated revenue for the first quarter of 2014 increased \$20.5 million, or 13 percent, from the same period in 2013. Net premiums earned for the Group increased 12 percent for the quarter, led by growth in our casualty segment which was up 25 percent. Net premiums earned from our surety segment showed modest improvement, up 2 percent, and helped to offset a 4 percent premium decline from our property segment. Net investment income increased 5 percent to \$13.6 million primarily due to a larger invested asset base and stable reinvestment rates. Net realized investment gains totaled \$6.5 million in the first quarter of 2014, compared to \$3.7 million in 2013.

Net after-tax earnings for the first quarter of 2014 totaled \$29.0 million, \$0.66 per diluted share, compared to \$24.8 million, \$0.57 per diluted share, for the same period in 2013. In the first quarter of 2014, favorable development on prior years' loss and catastrophe reserves resulted in additional pretax earnings of \$14.8 million. Comparatively, in the first quarter of 2013, favorable development on prior years' loss reserves resulted in additional pretax earnings of \$12.0 million. Results for both periods benefited from the absence of a significant catastrophe event. Bonus and profit sharing-related expenses associated with these specific items totaled \$1.8 million in 2014, compared to \$1.4 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 quarter of 2014, equity in earnings of unconsolidated investees totaled \$3.4 million. This amount includes \$3.3 million from Maui Jim and \$0.1 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 quarter of 2013 reflected \$3.5 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 \$46.7 million, \$1.07 per diluted share, for the first quarter of 2014, compared to \$42.4 million, \$0.98 per diluted share, for the same period in 2013. Unrealized gains, net of tax, for the first quarter of 2014 were \$17.7 million, compared to \$17.6 million for the same period in the prior year.

**RLI INSURANCE GROUP**

As reflected in the table below, gross premiums written for the Group increased 2 percent to \$197.4 million for the first quarter of 2014 from \$193.8 million in the first quarter of 2013. Growth from our casualty and surety segments, up 8 percent and 4 percent, respectively, offset a 9 percent decline from the property segment. Expansion efforts and new product initiatives, particularly within our casualty segment, have led to this result. Pricing trends have varied across our product portfolio, as select lines continue to see increases, while others have experienced flat or even declining rates. In our casualty segment, the positive pricing momentum seen in the prior year has largely slowed, while surety products continue to experience a flat overall rate environment. Rates on property coverages, however, have declined, as increased competition has resulted from light catastrophe activity in recent periods and from new capacity entering the market. In addition, net premiums written advanced 6 percent in the quarter. Growth in net premiums written has outpaced growth in gross premiums written, due largely to increased retentions selected for certain casualty products during the prior year and cost savings realized on our 2014 reinsurance renewals. In the beginning of 2014, we renewed our major property and casualty reinsurance treaties, which resulted in over \$10.0 million of annual savings while keeping our overall loss retentions largely unchanged. On a net premiums earned basis, premiums increased \$17.0 million, or 12 percent, due to overall growth experienced in recent periods. The casualty segment has contributed significantly to this growth, with net premiums written up 11 percent, and net premiums earned up 25 percent from the prior year quarter. Underwriting income for the Group totaled \$22.5 million for the first quarter of 2014, a \$2.7 million increase from the prior year. Results for both periods included favorable development on prior years' loss and catastrophe reserves, which improved underwriting results by \$13.3 million and \$10.8 million, respectively. The GAAP combined ratio for the first quarter totaled 86.0 in 2014 and 86.2 in 2013. The Group's loss ratio increased to 44.1, from 42.6, while the Group's expense ratio decreased to 41.9 from 43.6.

|                                       | For the Three-Month Periods<br>Ended March 31, |         |      |         |
|---------------------------------------|--|---------|------|---------|
|                                       | 2014   |         | 2013 |         |
| Gross premiums written (in thousands) |  |         |      |         |
| Casualty                              | \$   | 111,955 | \$   | 103,451 |
| Property                              |  | 58,153  |      | 64,020  |
| Surety                                |  | 27,290  |      | 26,321  |
| Total                                 | \$   | 197,398 | \$   | 193,792 |
| Underwriting income (in thousands)    |  |         |      |         |
| Casualty                              | \$   | 6,078   | \$   | 4,104   |
| Property                              |  | 9,678   |      | 10,924  |
| Surety                                |  | 6,776   |      | 4,770   |
| Total                                 | \$   | 22,532  | \$   | 19,798  |
| Combined ratio                        |  |         |      |         |
| Casualty                              |  | 93.3    |      | 94.4    |
| Property                              |  | 77.6    |      | 75.7    |
| Surety                                |  | 74.8    |      | 81.8    |
| Total                                 |  | 86.0    |      | 86.2    |

### *Casualty*

Gross premiums written for the casualty segment increased 8 percent, to \$112.0 million for the first quarter of 2014, compared to \$103.5 million from the same period last year. The top line has improved as both mature products and newer product initiatives have contributed to growth. Premium production has also benefited from modest rate increases on select lines, though on an overall basis upward pricing momentum for the segment has slowed. Our professional services product, which includes offerings to architects and engineers, posted gross premiums written of \$16.8 million, up \$3.5 million, or 26 percent, from the first quarter of 2013. Umbrella contributed to growth in the quarter, as premiums advanced 7 percent to \$30.6 million. Transportation also delivered solid results, with gross premiums written up 4 percent, while our new assumed casualty reinsurance business posted premiums of \$2.5 million in the quarter. The assumed casualty 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. Growth from these products offset declines from general liability and medical professional liability coverages, down \$0.4 million and \$0.6 million, respectively.

The casualty segment recorded underwriting income of \$6.1 million, compared to \$4.1 million for the same period last year. Both periods included favorable development on prior years' loss reserves. Products with favorable development in 2014 included general liability, umbrella and executive products. From an accident year standpoint, the majority of the favorable development occurred on more recent accident years (2008-2013). Due to positive emergence, during the first quarter of 2014 we released reserves which improved the segment's underwriting results by \$9.0 million. From a comparative standpoint, 2013 results included favorable development on prior accident years' loss reserves, primarily for general liability, executive products, P&C package and umbrella, which improved the segment's underwriting results by \$10.0 million.

Overall, the combined ratio for the casualty segment was 93.3 for 2014 compared to 94.4 in 2013. The segment's loss ratio was 57.8 in 2014 compared to 56.6 in 2013. The increase was driven by a slight reduction in favorable development on prior accident years' reserves, coupled with \$1 million of adverse experience on one product in the current accident year. The expense ratio for the casualty segment was 35.5 for the first quarter of 2014, compared to 37.8 in the prior year, due to improved leveraging of our expense base. Our election to increase retentions during the prior year has also contributed to the expense ratio decline.

### *Property*

Gross premiums written for the Group's property segment totaled \$58.2 million for the first quarter of 2014, a decrease of \$5.9 million, or 9 percent, from the same period last year. Premium production declined for multiple lines within the segment, as alternative sources of capital entered the market and served to decrease rates for catastrophe coverages. In addition, action taken to re-underwrite certain underperforming business has also contributed to premium declines. For example, our catastrophe-exposed assumed reinsurance programs decreased \$3.8 million, or 51 percent, from the same period last year, as we continued to exit certain underperforming programs within this

book. Our marine business also declined, down \$3.1 million, or 21 percent, from the prior year, due to ongoing re-underwriting efforts. Crop reinsurance premiums were down as well, lagging 2013 production by \$1.1 million, or 10 percent. Partially offsetting these decreases, our recreational vehicles program posted gross premiums written of \$4.1 million, which more than tripled the premium production in the prior year quarter. Premiums from our fire and Hawaii homeowners coverages also showed modest improvements.

Underwriting income for the segment was \$9.7 million for the first quarter of 2014, compared to \$10.9 million for the same period in 2013. Results for 2014 were impacted by favorable development on prior years' loss and catastrophe reserves which improved the segment's underwriting results by \$2.2 million. Included in this favorable development was a \$1.0 million reduction in losses related to Hurricane Sandy and 2013 spring storms. The majority of the favorable development was attributable to marine business. From a comparative standpoint, underwriting results for 2013 were improved by \$0.4 million due to favorable development on prior years' loss and catastrophe reserves.

Segment results for the first quarter of 2014 translate into a combined ratio of 77.6 compared to 75.7 for the same period last year. The segment's loss ratio increased to 35.5 in 2014 from 33.6 in 2013, due to higher loss ratios for the 2014 current accident year. From an expense standpoint, the segment's expense ratio for the first quarter was 42.1 for 2014 and 2013.

#### ***Surety***

The surety segment recorded gross premiums written of \$27.3 million for the first quarter of 2014, an increase of \$1.0 million, or 4 percent, from the same period last year. Premium growth was achieved despite continued intense competition in this market, which has resulted in flat pricing for most surety products. Commercial surety posted \$7.1 million of gross premiums written, up 14 percent, while contract surety advanced 10 percent to \$6.0 million. These increases more than offset a decline from our oil and gas product, which decreased \$0.4 million, or 8 percent.

The surety segment recorded underwriting income of \$6.8 million, compared to \$4.8 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 \$2.2 million. From a comparative standpoint, 2013 results included favorable loss development which improved the segment's underwriting results by \$0.4 million.

The combined ratio for the surety segment totaled 74.8 for the first quarter of 2014, versus 81.8 for the same period in 2013. The segment's loss ratio was 11.2 for 2014, compared to 19.2 for 2013, as both current and prior accident years' loss ratios improved. The expense ratio for the first quarter was 63.6 for 2014, compared to 62.6 in 2013.

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

Our investment portfolio generated net investment income of \$13.6 million during the first quarter of 2014, an increase of 5.4 percent from that reported for the same period in 2013. The increase in investment income was primarily due to a larger invested asset base and steady reinvestment rates. On an after-tax basis, investment income increased by 7.0 percent.





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| (in thousands)                  | 3/31/2014            |        |    | 12/31/2013           |        |  |
|---------------------------------|----------------------|--------|----|----------------------|--------|--|
|                                 | Financial Stmt Value | %      |    | Financial Stmt Value | %      |  |
| Fixed income                    | \$ 1,467,933         | 75.2%  | \$ | 1,440,703            | 74.9%  |  |
| Equity securities               | 426,680              | 21.9%  |    | 418,654              | 21.8%  |  |
| Cash and short-term investments | 57,648               | 2.9%   |    | 62,701               | 3.3%   |  |
| Total                           | \$ 1,952,261         | 100.0% | \$ | 1,922,058            | 100.0% |  |

Our current equity allocation represents 22 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.

Yields on our fixed income investments for the first three months of 2014 and 2013 were as follows:

|                        | 1Q 2014 | 1Q 2013 |
|------------------------|---------|---------|
| <u>Pretax Yield</u>    |         |         |
| Taxable                | 3.65%   | 3.54%   |
| Tax-Exempt             | 2.73%   | 2.71%   |
| <u>After-tax yield</u> |         |         |
| Taxable                | 2.37%   | 2.30%   |
| Tax-Exempt             | 2.59%   | 2.57%   |

The fixed income portfolio increased by \$27.2 million in the first three 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 2.4 percent. Average fixed income duration was 4.9 years at March 31, 2014, reflecting our current liability structure and sound capital position.

The equity portfolio increased by \$8.0 million during the first three months of 2014, to \$426.7 million, and had a total return of 3.6 percent through March 31, 2014.

We recognized \$6.5 million in realized gains in the first quarter of 2014, compared to realized gains of \$3.7 million in the first quarter of 2013. Realized gains during the quarter were primarily derived from equity sales as we rebalanced into fixed income assets, including a new allocation to high yield credit. We did not record any realized losses associated with OTTI of securities during the first quarter of 2014.

The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of March 31, 2014, including fair value, cost basis, and unrealized gains and losses.



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| (in thousands)         | Cost Basis | Fair Value | 3/31/2014 Unrealized |          | Net        | Unrealized Gain/Loss % (1) |
|------------------------|------------|------------|----------------------|----------|------------|----------------------------|
|                        |            |            | Gains                | Losses   |            |                            |
| Consumer Discretionary | \$ 13,450  | \$ 26,397  | \$ 12,947            | \$       | \$ 12,947  | 96.3%                      |
| Consumer Staples       | 14,923     | 36,848     | 22,084               | (159)    | 21,925     | 146.9%                     |
| Energy                 | 13,044     | 32,130     | 19,086               |          | 19,086     | 146.3%                     |
| Financials             | 26,575     | 49,291     | 22,716               |          | 22,716     | 85.5%                      |
| Healthcare             | 8,969      | 29,708     | 20,739               |          | 20,739     | 231.2%                     |
| Industrials            | 20,416     | 40,817     | 20,401               |          | 20,401     | 99.9%                      |
| Information Technology | 23,418     | 37,993     | 14,575               |          | 14,575     | 62.2%                      |
| Materials              | 3,030      | 8,137      | 5,107                |          | 5,107      | 168.5%                     |
| Telecommunications     | 8,541      | 16,146     | 7,802                | (197)    | 7,605      | 89.0%                      |
| Utilities              | 40,222     | 68,044     | 27,822               |          | 27,822     | 69.2%                      |
| ETF                    | 47,704     | 81,169     | 33,465               |          | 33,465     | 70.2%                      |
|                        | \$ 220,292 | \$ 426,680 | \$ 206,744           | \$ (356) | \$ 206,388 | 93.7%                      |

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

### INCOME TAXES

Our effective tax rate was 31 percent for the first three months of 2014 and 2013. Effective rates are dependent upon components of pretax earnings and the related tax effects.

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 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% | \$ 14,697 | 35% | \$ 12,589 | 35% |
| Increase (reduction) in taxes resulting from:           |           |     |           |     |
| Tax exempt interest income                              | (1,034)   | -2% | (815)     | -2% |
| Dividends received deduction                            | (598)     | -2% | (583)     | -2% |
| ESOP dividends paid deduction                           | (201)     | 0%  | (189)     | 0%  |
| Other items, net  | 158       | 0%  | 120       | 0%  |
| Total tax expense                                       | \$ 13,022 | 31% | \$ 11,122 | 31% |

### 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.

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The following table summarizes cash flows provided by (used in) our activities for the three-month periods ended March 31, 2014 and 2013:

|                      | 2014 | (in thousands) | 2013        |
|----------------------|------|----------------|-------------|
| Operating cash flows | \$   | (2,007)        | \$ (6,328)  |
| Investing cash flows | \$   | (10,748)       | \$ (10,367) |
| Financing cash flows | \$   | (6,096)        | \$ (5,248)  |
| Total                | \$   | (18,851)       | \$ (21,943) |

Cash flows from operating activities are typically lower during the first quarter due to the timing of reinsurance deposits, the cyclical nature of premium renewals and payment receipts, as well as outlays for bonus, retirement, and profit-sharing contributions. The combination of these factors resulted in cash used in operations for the first quarter of 2014. In addition, improved financial performance in 2013 resulted in increased bonus, retirement, and profit-sharing contributions relative to 2012.

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 March 31, 2014 was \$155.4 million. The fair value of our debt is estimated based on the limited observable prices that reflect thinly traded securities.

As of March 31, 2014, we had cash, short-term investments and other investments maturing within one year of approximately \$70.4 million and an additional \$194.7 million maturing between one to five years. As of March 31, 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.

We also maintain a revolving line of credit with JP Morgan Chase, which permits us to borrow up to an aggregate principal amount of \$25.0 million. Under certain conditions, the line may be increased up to an aggregate principal amount of \$50.0 million. The facility has a three-year term that expires on May 31, 2014. We are in the process of negotiating terms to replace this facility upon expiration and anticipate closing in mid-May 2014. As of and during the quarter ended March 31, 2014 no amounts were outstanding on this facility.

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

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

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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 March 31, 2014, our investment portfolio had a balance sheet value of \$2.0 billion. Invested assets at March 31, 2014, have increased \$30.2 million from December 31, 2013.

As of March 31, 2014, our investment portfolio had the following asset allocation breakdown:

### **Portfolio Allocation**

(in thousands)

| Asset Class                            | Cost or<br>Amortized Cost | Fair<br>Value       | Unrealized<br>Gain/(Loss) | % of Total<br>Fair Value | Quality*  |
|--|---------------------------|---------------------|---------------------------|--------------------------|-----------|
| U.S. agency                            | \$ 2,000                  | \$ 1,997            | \$ (3)                    | 0.1%                     | AA        |
| Corporate                              | 543,143                   | 565,581             | 22,438                    | 29.0%                    | A         |
| Mortgage-backed                        | 236,341                   | 239,148             | 2,807                     | 12.2%                    | AA        |
| ABS/CMBS**                             | 105,440                   | 105,806             | 366                       | 5.4%                     | AAA       |
| Non-U.S. govt. & agency                | 13,852                    | 14,588              | 736                       | 0.7%                     | A         |
| U.S. government                        | 18,205                    | 18,395              | 190                       | 0.9%                     | AA        |
| Municipal                              | 519,293                   | 522,446             | 3,153                     | 26.8%                    | AA        |
| <b>Total Fixed Income</b>              | <b>\$ 1,438,274</b>       | <b>\$ 1,467,961</b> | <b>\$ 29,687</b>          | <b>75.1%</b>             | <b>AA</b> |
| <b>Equity</b>                          | <b>\$ 220,292</b>         | <b>\$ 426,680</b>   | <b>\$ 206,388</b>         | <b>21.9%</b>             |           |
| <b>Cash and short-term investments</b> | <b>\$ 57,648</b>          | <b>\$ 57,648</b>    |                           | <b>3.0%</b>              |           |
| <b>Total Portfolio</b>                 | <b>\$ 1,716,214</b>       | <b>\$ 1,952,289</b> | <b>\$ 236,075</b>         | <b>100.0%</b>            |           |

\*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.

As of March 31, 2014, our fixed income portfolio had the following rating distribution:

|            |              |
|------------|--------------|
| <b>AAA</b> | <b>16.2%</b> |
| <b>AA</b>  | <b>44.5%</b> |
| <b>A</b>   | <b>25.3%</b> |
| <b>BBB</b> | <b>9.7%</b>  |
| <b>BB</b>  | <b>3.3%</b>  |
| <b>B</b>   | <b>1.0%</b>  |
| <b>NR</b>  | <b>0.0%</b>  |

|              |               |
|--------------|---------------|
| <b>Total</b> | <b>100.0%</b> |
|--------------|---------------|

As of March 31, 2014, the duration of the fixed income portfolio was 4.9 years. Our fixed income portfolio remained well diversified, with 811 individual issues as of March 31, 2014.

Our investment portfolio has limited exposure to structured asset-backed securities (ABS). As of March 31, 2014, we had \$20.6 million in ABS which are pools of assets collateralized by cash flows from several types of loans, including home equity, credit cards, autos and similar obligations. The majority of our asset-backed portfolio is comprised of rate reduction utility bonds.



As of March 31, 2014 we had \$85.2 million in commercial mortgage backed securities (CMBS) and \$239.1 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 5.4 percent of our investment portfolio at quarter end.

We had \$565.6 million in corporate fixed income securities as of March 31, 2014. During the first quarter of 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 March 31, 2014, we had \$31.7 million invested in the strategy.

We also maintain an allocation to municipal fixed income securities. As of March 31, 2014, we had \$522.4 million in municipal securities. As of March 31, 2014, approximately 91 percent of our municipal bond portfolio maintains an AA or better rating, while approximately 99 percent of the municipal bond portfolio is rated A or better.

At March 31, 2014, our equity portfolio had a fair value of \$426.7 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 March 31, 2014, our equity portfolio had a dividend yield of 2.8 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 81 individual names and no single stock exposure greater than 3 percent of the equity portfolio.

Our capital structure is comprised of equity and debt outstanding. As of March 31, 2014, our capital structure consisted of \$149.6 million in 10-year maturity senior notes maturing in 2023 (debt) and \$869.6 million of shareholders' equity. Debt outstanding comprised 14.7 percent of total capital as of March 31, 2014. Interest and fees on debt obligations totaled \$1.9 million during the first three months of 2014 compared to \$1.5 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 three months of 2014 compared to 6.02 percent for the same period in the prior year.

We paid a quarterly cash dividend of \$0.17 per share on March 20, 2014, the same amount as the prior quarter. We have paid dividends for 151 consecutive quarters and increased dividends in each of the last 38 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 March 31, 2014, our holding company had \$869.6 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 \$22.9 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 three months of 2014, there were no dividends paid by our principal insurance subsidiary 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 March 31, 2014, \$145.7 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 86 percent rated A or better by at least two nationally recognized rating organization.

On an overall basis, our exposure to market risk has not significantly changed from that reported in our December 31, 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 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** - There were no material changes to report.

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

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

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

Our current \$100 million share repurchase program was implemented by our Board of Directors in May 2010. The repurchase program may be suspended or discontinued at any time without prior notice. During the first 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

**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

**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: April 28, 2014